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FROM PLAN TO MARKET: THE POST-SOVIET CHALLENGE
PART II

Gavriil K. Popov	Moscow's Testing Ground for New Forms of Economic and Political Life
Peter Bauer	Western Subsidies and Eastern Reform *Comment by* **Doug Bandow**
Oleg T. Bogomolov	Half or Full Reform? *Comment by* **William A. Niskanen**
Roger Pilon	Individual Rights, Democracy, and Constitutional Order: On the Foundations of Legitimacy
Ralph Raico	Liberalism, Marxism, and the State
Paul Craig Roberts	Privatization Solves All
Peter Bernholz	Property, Markets, and Money *Comment by* **Edwin G. Dolan**
Don Lavoie	Glasnost and the Knowledge Problem: Rethinking Economic Democracy
Fred L. Smith, Jr.	A Free-Market Environmental Program
Douglass C. North	Institutions, Ideology, and Economic Performance *Comment by* **Vitali Naishul**

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FROM PLAN TO MARKET: THE POST-SOVIET CHALLENGE PART II

Gavriil K. Popov
Moscow's Testing Ground for New Forms of Economic and Political Life 337

Peter Bauer
Western Subsidies and Eastern Reform 343

Comment by **Doug Bandow** 355

Oleg T. Bogomolov
Half or Full Reform? 361

Comment by **William A. Niskanen** 369

Roger Pilon
Individual Rights, Democracy, and Constitutional Order: On the Foundations of Legitimacy 373

Ralph Raico
Liberalism, Marxism, and the State 391

Paul Craig Roberts
Privatization Solves All 405

Peter Bernholz
Property, Markets, and Money 409

Comment by **Edwin G. Dolan** 425

Don Lavoie
Glasnost and the Knowledge Problem: Rethinking Economic Democracy 435

Fred L. Smith, Jr.
A Free-Market Environmental Program 457

Douglass C. North
Institutions, Ideology, and Economic Performance 477

Comment by **Vitali Naishul** 489

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Moscow's Testing Ground for New Forms of Economic and Political Life

Gavriil K. Popov

We now face a problem of exceptional importance to the fate of civilization: the transition to the new society of that third of the human race which, a mere five years ago, was guided by state-administrative socialism as the model of a better society. Today, most citizens are convinced of the need for a transition to a different social model. What is it that we must ultimately do?

The Path toward Freedom

First, we must make the transition to a new type of economy. Its key feature will be multiple forms of ownership instead of the domination of state ownership. In this diversity, nongovernmental forms will prevail, that is to say, private and collective property. The state sector will remain as an important but subordinate element, mostly in the form of municipal property. This economy will have markets, competition, and all related structures—from convertible currency to a stock exchange.

Second, we must make the transition to a democratic state, which is based on a multiparty system as a necessary superstructure over pluralistic forms of ownership. Political freedom is both a precondition and a consequence of a market economy.

Third, we must accomplish the transition from the monopoly of a single state ideology to the right to freely choose any ideological views, from religion to atheism, from socialism to anticommunism. Only humanity-hating, racist, and other such viewpoints should be excluded.

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The author is Mayor of Moscow and Professor of Economics at Moscow State University. This paper was originally delivered as a luncheon address at the Cato Institute's conference "Transition to Freedom: The New Soviet Challenge," in Moscow, September 11, 1990.

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Fourth, we must overcome the imperial, essentially unitary ties between our peoples; we must overcome the state that is concerned about the development of nationalities only to the extent that it serves the fortification of the empire. All peoples must decide their own destinies, and the forms of their coexistence must stem from the freely expressed will of those peoples.

The Question of Implementation: Setting the Political Stage

We have achieved a certain mutual understanding with regard to the goals of reforms, and even the 28th Congress of the CPSU, in the sixth year of the perestroika launched by the party, was forced to recognize these goals (though far from all delegates cast their votes). But the question of *how to effect* the realization of these goals has yet to be resolved.

The initial idea was that perestroika would be led by the majority of the Politburo of the Central Committee of the CPSU, using the existing party *apparat* as its instrument. One apparent argument in favor of this option was the *apparat* was allegedly obedient and willing to follow any directive from the top.

But by late 1987 it was clear that this option would not work. The *apparat*, it turned out, quickly realized that a successful perestroika would render it superfluous in its present form, and it was not active in the cause of change.

Then, the idea of restructuring the government and party *apparat* itself was set forth. But while this idea was correct in itself, this proposed option of perestroika was doomed by the fact that, in most regions of the country, the *apparat* itself was the dominant force. As a result, the idea of restructuring the *apparat* turned into a project that suited the *apparat* itself. A peculiar alliance emerged, composed of the leadership of the country, the Mikhail Gorbachev team, and the *apparat* forces. This center-right bloc was dominant in the country until recently; in its new form, it has been institutionalized by the results of the 28th Congress.

This bloc can carry out change only in such forms and on such a timetable as the *apparat* considers acceptable. As a result, the country can change only at the speed that suits the *apparat*. And since the latter as a product of bureaucratic socialism is most compatible with a new social model, this means that of all the possible options of perestroika, the one that was used was the most realistic but also the least effective one. The entire group, as it were, had to move at

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the same pace as its weakest member. This situation could not but cause a wave of growing discontent throughout the country.

The elections to the republican and local councils were a reaction to the ineffectiveness of the center-right bloc. In these elections, the radical bloc was able to win the majority in the parliaments of several republics and in a number of local councils. New political zones emerged. A base was created for the emergence and acceptance of a new type of mechanism of perestroika.

What will this new option be like? The democrats assess the situation realistically; they do not believe in proposing a complete takeover of the leadership of perestroika by the radical forces. For the USSR today, this would be utopian. But this is not only a question of realism; it is a question of the essence of our stance. If we want a democratic, multiparty society, it would make little sense to replace the total control of one force with the total control of another, even if the former is very conservative and the latter, at present, radical. We know from our experience of 1917 how easily radicals and democrats turn into dictators.

Therefore, our policy is one of coalition building. We need a coalition of all the forces that stand for the accomplishment of all the goals of perestroika I outlined above. Analysis shows that this will be a center-left coalition. However, the radical forces will be shorn of their extremist fringe. On the other hand, the most realistic members of the *apparat* from the conservative camp will join this bloc. At the present stage, this coalition must be headed by centrists.

So far, we have had no success in implementing this option, precisely because of the negative attitudes of the center. Mikhail Gorbachev is not yet quite ready for such a coalition. In Russia, Boris Yeltsin is trying to implement this option, but the center still regards him as a radical, and it is difficult for him to be a unifying force, though he is successfully moving along this track.

On a lower level, however—particularly in Moscow and Leningrad—a special kind of coalition has formed: a coalition without a center, a coalition of radical forces in the elected bodies with realistic members of the *apparat*. This is not a center-left coalition dominated by the center, but a radical-*apparat* coalition dominated by the democrats.

Which of these options will win? I am doing and shall do all I can to make the type of coalition we have in Moscow succeed. On the whole, however, I advocate a center-radical coalition as the most appropriate to the situation we now face. The real question is whether Mikhail Gorbachev will be able to take a step to the left toward such a coalition—or whether Boris Yeltsin will be able to

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take a step to the right toward the same coalition. Both of them are facing difficult tasks.

In the meantime, here in Moscow, we are trying to carry out the kind of changes that are feasible within the limits of the authority and the opportunities of one city. They are complicated both by the status of our city as the capital of the USSR and of the Russian Republic, and by its size: nine million people in the city and another six million in the Moscow area.

Economic Reform in Moscow

We want to make the residents of Moscow owners of their housing as quickly as we can. The Moscow City Council has made a decision to turn over government-owned apartments to their tenants—if the tenants so desire, of course. This transfer will be free of charge within the limits of the average norms of housing space per person, with extra fees only for space above this norm. Moscow will have a housing market. We will create the conditions for abolishing the resident permit system, one of the bulwarks of state socialism. In a word, an important step will be made toward the economic and political freedom of the citizen.

Another important measure is the privatization of trade in Moscow. The Moscow City Council has made a decision to transfer state-owned stores and wholesale trading companies to private owners, cooperatives, and stock companies. Here, too, we intend to transfer the basic resources—buildings and equipment—free of charge. Our principle is this: Every citizen is entitled to his share in the country's wealth, and within the limit of this share in the heritage of socialism he should—as he parts from the state sector and becomes a private owner—receive everything free of charge, whether it is housing or a store. If the present staff of a store does not want to take it, it will be auctioned off.

The privatization of trade makes sense if the owner has the right to freely set prices. However, in the situation we have now, this would mean nothing but a price hike. Therefore, the Moscow City Council has the obligation to protect the interests of Muscovites, to avoid provoking anti-market hostilities among the population. For the solution, we are looking to the following scheme: fixed prices on a number of goods in special Moscow money and free prices in ordinary rubles. Every Muscovite can receive a portion of his salary in Moscow rubles. There will be a bank for the exchange of Moscow rubles and ordinary ones; there will also be a rate of exchange. This is the beginning of the process that will result in a convertible ruble.

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For the time being, we will have three levels: hard currency, Moscow rubles (backed with goods), and ordinary rubles.

And, finally, I would like to note the following measure: day-care centers will now charge full fees, while the funds that used to be spent by the Moscow City Council on maintaining day-care centers in the city will be given directly to the parents. Instead of the Moscow City Council, parents themselves will be in charge of day-care centers. Here, too, we will be making an important step toward the freedom of the family and the individual.

I could speak of other steps as well: the creation of a stock exchange, real estate auctions, the creation of the Moscow bank as a lending institution including hard-currency credit, and many other things.

A Society of Enterprise and Democracy

Here in Moscow, we see our task as one of making our city a testing ground for new forms of economic and political life, of giving the country models for solving its problems.

Our work is difficult. We are trying to solve a historically unprecedented task: to denationalize and privatize something that has never been private, that has been, from the very beginning, created as state property. And we must give this property to citizens who have never been private owners, in a country where no equivalent of the private sector exists, and where there is no experience of private enterprise.

In our work, we are counting on support and aid from Western countries. Today, Western aid to Moscow radicals not appointed by Gorbachev is, paradoxically, of much greater benefit to Gorbachev himself than is direct aid to the Ryzhkov government appointed by him. Aid to the federal government may be, as it repeatedly was in the past, simply wasted or consumed; or, worse yet, it may serve to maintain outmoded structures.

We believe that Western aid is needed immediately, but it must go to those structures in the USSR that are capable of making it an instrument of transition from a society of egalitarianism, bureaucracy, and passive consumption to a society of enterprise and democracy. Moscow is one such structure.

And we hope that this conference will be a contribution both to Western understanding of our problems and to the development of a Western strategy in dealing with the USSR that will help speed up our perestroika. We must, as soon as possible, make the USSR a

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real partner of Western countries, a partner in ordinary, mutually beneficial trade.

Of course, we could accomplish perestroika by ourselves. We can bear our own cross. But with the right kind of support from the West, our road will be an easier and shorter one.

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Western Subsidies and Eastern Reform

Peter Bauer

Western subsidies to reformist governments in Eastern Europe are not generally necessary for the prosperity of these countries and the survival of their governments. The contribution of such subsidies is at best very limited. They are more likely to be damaging. In certain clearly defined exceptional circumstances, reflecting not poverty as such but other legacies of Communist rule, modest support preferably as bilateral grants, might be helpful. But reduction in the trade barriers against exports from these countries would be far more effective.

Conventional Arguments for Subsidies

Official subsidies to governments of poor countries are widely seen in the West as a moral, political, and economic imperative. Their progress is said to be of vital importance to the West and it is regarded as impossible without external subsidies. The core argument, popularized as the vicious circle of poverty, has been the central theme of post-war development economics. It was concisely formulated by Nobel Laureate Paul Samuelson (1951, p. 49): "They [the backward nations] cannot get their heads above water because their production is so low that they can spare nothing for capital formation by which the standard of living could be raised."

This argument is refuted by every individual, family, group, community, and country that has emerged from poverty without subsidies. If the argument were valid, we should still be in the Old Stone Age.

Provided they are motivated to improve their lot and are not inhibited by government policy or lack of public security, poor people can

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The author is Emeritus Professor of Economics at the London School of Economics, University of London, and a Fellow of the British Academy.

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and do generate or secure sufficient funds for economic advancement. They can save enough even from small incomes for direct investment in agriculture, trading, and many other purposes. They can also work harder or longer or redeploy their resources more productively.

Governments and enterprises of poor countries have access to commercial external funds. Ability to borrow abroad does not depend on the level of income but on responsible financial conduct and productive use of funds.

If property rights are clearly defined and reasonably protected, external commercial funds are available even in the face both of poverty and political risk. Since World War II much foreign investment has taken place in Asia and Africa amid acute political uncertainty. Substantial investment trusts targeted to Eastern Europe have already been established in the West. And Western corporations have set up thousands of joint ventures and subsidiaries in Eastern Europe, including the Soviet Union—that is, in countries where political risk is compounded by an incompletely developed legal system. The skills and attributes that accompany the inflow of equity capital can play the same role in Eastern Europe in transforming methods and habits as they did in many less developed countries (LDCs).

Thus subsidies are not necessary for emergence from poverty. It is indeed an unwarranted and distasteful condescension to argue that while the peoples of poor countries crave material progress, they cannot achieve it without subsidies from the West.

Nor are subsidies sufficient for advance. The many billions of official aid both from the West and the Communist Bloc to Ethiopia, Sudan, and other African countries have not secured their progress. To have money is the result of economic achievement, not its precondition.

The Politicization of Life

Although subsidies are demonstrably neither necessary nor sufficient for economic advance, it may seem self-evident that they must promote it because they are an inflow of resources. However, this does not follow. This inflow sets up adverse repercussions that can far outweigh any benefit. Some arise whether the subsidies go either to the public or to the private sector; others arise because they go to or through recipient governments.

An inflow of capital raises the real rate of exchange and thereby impairs foreign trade competitiveness. With equity capital this is

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usually offset by increased productivity of resources, but that is unlikely with official subsidies.

External subventions promote or reinforce the belief that economic improvement depends on outside forces other than domestic effort. Subsidies encourage governments to seek foreign assistance through beggary or blackmail instead of looking to change at home. Such attitudes often spread from the government or other groups.

Unlike manna from heaven, which descends on the whole population, these subsidies go to the government. They therefore increase its resources, patronage, and power, compared to the rest of society. External subsidies have also helped to sustain governments especially in Africa, whose policies have proved so damaging that only the subsidies have enabled them to remain in power and continue with such destructive policies. Altogether, the subsidies have contributed significantly to the politicization of life in recipient countries.

When life is extensively politicized, people's fortunes come to depend on government policy and administrative decisions. The stakes, both gains and losses in the struggle for power, increase greatly. This encourages or even forces people to divert attention, energy, and resources from productive activity to concern with the outcome of political and administrative decisions.

Politicization of life provokes tension and conflict, especially in countries with different ethnic and cultural groups as in much of the Third World and Eastern Europe. Groups and communities that have lived together peaceably for generations have been set against each other by the politicization promoted by these official subsidies.

Subsidies also make it easier for governments to restrict the inflow of foreign capital, especially equity capital. Aid-recipient governments commend inward foreign equity investment but in practice restrict it because this suits their political purposes and the commercial interests of their supporters.

These restrictions are plainly anomalous when the argument for external subsidies is a shortage of capital. Inflow of equity capital—together with the commercial, administrative, and technical skills that accompany it—have been the prime instrument of the economic advance the world over.

Reformist governments in Eastern Europe are less likely to restrict the inflow of equity investment than LDC governments. But cushioned, by external subsidies, they could still be tempted to do so for political reasons.

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A Double Asymmetry in the Effects of Official Subsidies

Economic advance depends on personal, cultural, and social factors and political arrangements; it does not depend on the cost and volume of investable funds. And because commercial capital from abroad is available to people who can use it productively, it follows that the maximum contribution external subsidies make to economic advance cannot exceed the avoided cost of borrowing, that is, the interest and amortization charges that would have been payable to the creditors as a proportion of GNP.

Thus the most subsidies can do is to reduce the cost of a resource that is not a major factor in economic advance. Any possible benefit would be too small to register in GNP statistics. And as we have seen, the inflow of subsidies sets up adverse repercussions that affect critical political and social factors.

There is a double asymmetry in the effects of official subsidies. First, any favorable effect through the reduction in the cost of investable resources affects a factor not critical for economic advance, while major adverse effects operate on critical determinants. Second, a volume of subsidies too small to benefit economic performance appreciably is nevertheless amply sufficient to set up the adverse effects. It is the relationship of the subsidies to GNP that is relevant to the favorable effect, namely, a reduction in the cost of investable funds. And because the subsidies go to governments, it is the relationship of the subsidies to government receipts and foreign exchange earnings (themselves readily subject to government control) that is relevant to major adverse repercussions. Because GNP is necessarily a large multiple both of tax receipts and foreign exchange earnings, the subsidies must be far larger relative to these magnitudes than to GNP.

It is unequivocal that external subsidies are neither necessary nor sufficient for economic advance. Whether they promote or retard it cannot be established so conclusively. But this uncertainty in no way affects the conclusion that the subsidies can do no more for development than the avoided cost of borrowing and that this modest contribution tends to be offset by adverse repercussions.

It is crucial to recognize that the subsidies entail major adverse consequences. Belief that an inflow of resources must benefit the population at large, and certainly cannot harm it, has promoted the uncritical acceptance of foreign subsidies. Once the damaging repercussions are recognized, a less questioning stance might come to be adopted.

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Subsidies as a Device to Maintain Government Power

Although government-to-government subsidies can do little or nothing for economic achievement and advance, they can alleviate acute shortages, especially of imports. By maintaining a minimum level of consumption, the subsidies avert total collapse and conceal from the population, at least temporarily, the worst effects of destructive policies. This result, in turn, helps the government to remain in power and to persist with these policies without provoking popular revolt.

The same process can also apply in reverse. If a shortage of necessities develops for reasons outside the control of the government, and for which no provision could have been made, subsidies might help the government to survive. As we shall see, this possibility bears on Western assistance to the reformists.

Government Policy and Economic Advance

Multiparty democracy is widely seen as a necessary condition of a market system and of economic improvement. Multiparty democracy may well be desirable. But what matters for economic advance, especially improved living standards, is not how the government is established but what is envisaged as its tasks. Whatever its origins, a government is most likely to promote the economic advance and well-being of the people by the effective performance of a specific range of tasks while refraining from extensive control of economic life.

The list of tasks is familiar: public security, which means protection of life and property, including the definition of property rights; maintenance of the value of money; management of external relations in the interests of the population; provision or oversight of basic education, public health, and transport; assistance to those in need who cannot help themselves and are not helped by others. It is by combining these functions with restriction on state economic control that a government can most effectively promote personal freedom and economic welfare.[1]

Obstacles to Liberalization

In the West, in public discourse on reform in Eastern Europe, introduction of multiparty democracy and establishment of a market

[1]In some instances the subsidies go through the government for subsequent allocation to other entities. In the present context the distinction is immaterial as the distribution and use of the funds require official sanction.

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system are usually linked or even identified. This practice is misleading. Multiparty democracy may well be thought beneficial for various reasons, such as conferring legitimacy on a government reducing the dependency of people on a single ruler or party. But the two types of reform are quite distinct. Establishment of a market system from scratch is far more difficult than introducing multiparty democracy.

Reformists in the Soviet Union and elsewhere in the East recognize that replacement of the command economy by a market system is indispensable for economic reform or even for averting economic collapse. Accordingly, they try with differing degrees of commitment to dismantle the command economy. In doing so they attempt an unprecedented task. In the course of history, ruling groups have often introduced a new constitution or established and extended the suffrage. But there is no recorded instance of a government introducing a market system where there was none before. In the West the institutions, attitudes, and modes of conduct of a market order have emerged in the course of centuries of sustained social and economic evolution. People in the Soviet Union have never known a functioning market system and its arrangements. To take a simple example, job search is practically unknown to people in the Soviet Union. They were directed into jobs from the time they left school. This is also true, to a lesser extent, in Eastern Europe. The attempt to establish a market system from scratch is therefore inevitably a leap in the dark.

In the post-Communist countries, the hazards and difficulties of this leap are much exacerbated by major legacies of the command economies. In particular, two distinct but interacting obstacles stand in the way of market-oriented reform: unpreparedness of the people and hostility of the bureaucracies and other established interests.

People who have spent their entire adult lives under a comprehensive command economy are necessarily unfamiliar with a market economy. They face severe difficulties of adaptation that they do not relish. Under the command economy, people's economic fortunes depended on the government. People were not looking for jobs and activities but were directed into them. People were engaged in activities in which production was divorced from the supply of valuable commodities and where output was measured by the cost of inputs, which was unrelated to economic cost. Such people are bewildered by the market system. They find it difficult to accept the opportunities, risks, and rewards of the market. They attribute any economic reverse to malice or exploitation.

Many people in these countries are most apprehensive about the effects of extensive reform on their own fortunes. They fear the steep

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rises in prices and housing costs following the removal of subsidies and controls and the withdrawal of state-provided health services.

Reformist governments inevitably have to rely extensively on existing personnel in the public services, including the military, the police, the civil service, the public utilities, and the state enterprises. On grounds both of self-interest and ideology, much of this personnel is opposed to the dismantling of the command economy. They try to frustrate reform by stirring up popular discontent and apprehension and by denying supplies to the private sector or to areas of activity controlled by the reformists. They cannot be expected to surrender, without resistance, the power, positions, and privileges they enjoy. As U.S. Senator Strom Thurmond said, "You can't get a hog to butcher itself." Altogether there is much latent and open opposition to the market system. More international trade and investment could help to overcome some of this hostility, especially through acquainting people with the market order.

Gradual versus Radical Reform

Faced with these daunting difficulties, two distinct schools of thought have emerged among committed reformists in Eastern Europe: gradualists and radicals. The former argue that the population is not ready for far-reaching change and would respond by resistance, even revolt, or by lethargy and listlessness. They recognize that people, whether as individuals, families, or entire societies, cannot readily absorb abrupt changes. The radicals argue that slow, gradual change enables opponents to marshal their forces and that delay extends the period of unpopularity aroused by reform. They urge that half measures are more likely to discredit the market system than to make it more acceptable. Academician Arbator has written that a small market sector within a largely state-controlled Soviet economy is as unlikely to thrive as a vine grafted onto a telegraph pole.

Strangers to a country and to its political culture are poorly qualified to judge between gradual and rapid change. Two observations favoring the radicals may be in order.

In the West, proposals for economic reform have often elicited dire predictions about the outcome. These predictions have usually been disproved by the results. Examples include the German currency reform of 1948 and Thatcherite policies of the 1980s.

Comprehensive reform need not be shock therapy causing widespread acute hardship. If the measures for reform are carefully thought out, especially the sequence of different measures, the

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reforms need not involve extensive hardship. Moreover, some of the changes such as decontrol of prices and rents that harm some groups benefit others. Compensation paid to the former could be financed at least in part by taxation of the beneficiaries.

What Can the West Do?

There are several things the West can do to promote economic advance in Eastern Europe. First and foremost, Western countries should reduce their trade barriers. Eastern Europe would benefit because international trade acquaints people with the market system; helps to allay suspicions about its operation; and promotes market-oriented attitudes, habits, and conduct, which would emerge only from direct experience.

Although reduction of Western trade barriers can be a potent instrument for economic advance in the circumstances of Eastern Europe, more may be needed to assist the reformists. Hostility to the market by the bureaucracies and popular fears could inhibit economic advance and could also create shortages long before the government can accumulate reserves against such contingencies. Foreign loans may then also be very expensive. To service them may absorb much of the benefits of reform, which would be sufficiently unpopular politically to endanger the government. Even large inflows of commercial capital may not avert such dangers. Such investment benefits the economy as a whole and enlarges the tax base, but does not promptly make funds available to the government. Under these circumstances, subsidies might secure the survival of market-oriented reformist governments by alleviating acute shortages, notably of imports.

This argument for external subsidies hinges on the legacies of Communist rule and is altogether different from that based on poverty. This difference is important for the timing and method of the subsidies. These subsidies should be provided only to governments irrevocably committed to promotion of the market economy. Such reform is both difficult and unpopular. It will be pursued only if without it economic collapse would endanger the government. If subsidies are provided ahead of far-reaching reforms, the reforms will be postponed or abandoned—perhaps forever. Meanwhile, subsidies facilitate the maintenance of military establishments.

Subsidies should be grants not soft loans. President Gorbachev has said that while he would not accept aid he would welcome low-interest loans. But these also represent subsidies: Soft loans or government guaranteed loans compose a substantial grant element. They

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also confuse investment with handouts, and they provoke tensions between donors and recipients: Donors see them as assistance; recipients see them as a burden.

The grants should be for a strictly limited period, say three years. This period would be long enough to overcome the obstacles of bureaucratic hostility and popular apprehension. If those obstacles cannot be overcome in a few years, then the support should be withdrawn. Equally if they are overcome, no further support is necessary.

Bilateral grants (going directly from donor to recipient government) are far preferable to multilateral grants (going through the international organizations). The bilateral method permits a vestige of control by the taxpayers, the real donors; termination of bilateral subsidies in the face of wasteful or destructive policies is far easier; a measure of conduct between supplier and user of funds also makes for greater effectiveness; and self-perpetuation and self-aggrandizement can be somewhat more readily restrained.

Another advantage of bilateral subsidies is of special importance in our context. They need to be administered by people wholly in sympathy with the dismantling of the command economy. Such people are even less likely to be found in the international organizations than in the national bureaucracies. The international organizations attract people with a dirigiste or socialist outlook, perhaps because of the distance of these organizations from grassroots politics.

The international organizations do not command expertise not available otherwise. Any specialized knowledge can be readily purchased by the national government departments.

The oft-heard claim is unfounded that the international organizations are disinterested and objective and that, therefore, subsidies allocated by them are more likely to be effective. In fact, the delegates and staffs of these organizations have distinct personal and political interests, which the more energetic and ambitious among them pursue vigorously.

It is often said that the reformists need technical assistance rather than financial support, especially for the development of the human and financial substructure, such as accountants, lawyers, tax inspectors, and computer personnel. But the reformists can purchase these resources. They know best which experts they require and how many of each kind.

Subsidies for general purposes seem preferable to project subsidies. It is easier to secure commercial funds for the latter. And after decades of command economies, it is necessary that people should

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understand that projects ought to cover their economic costs; specific subsidies obscure this.

Altogether, the recipients ought to be free to spend the subsidies in whatever direction they think will suit their purposes. If they are thought to deserve financial support, they should be given wide latitude in spending the money. They may even use some funds to pay off redundant personnel to mitigate opposition to reform, or to use it to service debt if they think this would help the credit worthiness of their countries.

It is widely urged that the sovereign debt of Eastern countries should be scaled down or even forgiven altogether as a form of support. Such suggestions raise awkward problems. In general, blanket debt reduction or cancellation specifically rewards the incompetent, profligate, and dishonest compared to those ready to meet their obligations. But the reformists can plausibly argue that they should not be saddled with debts contracted by the rulers of command economies when they themselves are trying to replace the command economy by market order. They can, and do, argue that their predecessors dissipated the loans in directions that have not yielded productive assets. This contention is in no way affected by the fact that much or most of the indebtedness was incurred through subsidized loans from the West.

On the other hand, wholesale default on sovereign debt, however contracted, goes counter to attempts to establish and maintain property rights, a measure that is crucial to the operation of a market system. Perhaps the least of the evils would be if reformist governments were to make sustained, modest payments on the debts contracted by their predecessors. Similarly, some compensation for confiscated property, where its owners or their legitimate heirs are identifiable, would promote confidence in the maintenance of property rights.

The effect of subsidies in raising the real exchange rate and thereby impairing international competitiveness could be minimized by paying the funds into special accounts in the West on which the recipients could draw for buying imports.

Such subsidies involve costs and risks. But these need not be heavy if support goes to committed reformists for a strictly limited period, and if donors are prepared to cut off funds when they recognize failure in the course of that limited period.

There are also risks in refusing support. If the reformists go under and this can be plausibly attributed to lack of external assistance, this failure would undoubtedly lead to demands for much increased subsidies to LDCs. Demise of the reformists would threaten the West

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with a flood of refugees and might also pose a real or fictitious security risk.

Conclusion

The thrust of public discussion, as well as the measures already taken, differ radically from the arguments outlined here. It is the low level of incomes in the Soviet Union and Eastern Europe, rather than the specific legacy of Communist command economies, that is envisaged as the ground for support. Financial assistance, rather than freer trade, is in the foreground. The international organizations, notably the World Bank, the IMF, the European Commission, and the Bank for European Reconstruction and Development, are envisaged as the sources, arbiters, and channels of subsidies. Substantial subsidies have already been provided without any assurance of commitment to reform.

The currently adopted and envisaged methods of assistance to the Eastern governments do not reflect the merits of the case, but rather the climate of opinion, the play of political forces, and above all the influence of the aid lobbies, especially the international organizations, in politics, the media, and the academies.

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The Pitfalls of External Aid

Doug Bandow

Virtually everyone in the West is rejoicing over President Mikhail Gorbachev's commitment to glasnost and perestroika. The Soviet Union's rush away from Stalinism, Moscow's willingness to allow Eastern Europe to move toward full democracy and independence, and the waning of the Cold War have combined to present former adversaries with a unique opportunity to cooperate economically as well as culturally and politically.

Unfortunately, however, many people in both the East and West are proposing significant "aid" to reform governments in Eastern Europe and the USSR. The widespread pressure for large-scale financial transfers makes Peter Bauer's paper a particularly important one. It should be read by officials in Washington as well as Moscow.

Forty Years of Failure

Peter Bauer's basic thesis—that "Western subsidies to reformist governments in Eastern Europe are not generally necessary for the prosperity of these countries and the survival of their governments"—is absolutely correct. We have had roughly 40 years of experience with foreign aid, both bilateral and multilateral, and the results have been quite disappointing. Very few recipients of foreign aid have ever subsequently shown economic success: South Korea and Taiwan are a couple of very rare exceptions, and they probably prospered in spite of, rather than because of, the money they received from the U.S. government.

Reform Begins at Home

Unfortunately, receipt of foreign assistance has a number of deleterious consequences. Perhaps the most fundamental problem, one

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The author is a Senior Fellow at the Cato Institute.

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touched on by Bauer, is that international transfers encourage the belief that outside forces control the development process. That is, many people, including those in poorer countries themselves, believe that foreign aid is necessary for their nations to grow and prosper. Thus, they do not critically examine domestic conditions that may inhibit development.

This is a very real danger for the Soviet Union and the Eastern European countries that are attempting to reform their economies. Rigid central planning has proved to be a disaster; only a transition to a market economy can get these countries moving again. But if public officials and average citizens alike place their hopes in receiving funds from abroad and lose sight of the many politically difficult domestic reforms that are necessary, they will find themselves growing poorer, not richer.

How can reform governments and, more importantly, domestic industries seeking to modernize and become efficient, acquire the necessary capital? Bauer's point about what justifies international loans is particularly important. As he explains, "Ability to borrow abroad does not depend on the level of income but on responsible financial conduct and the productive use of funds." Although Western banks have finally—and wisely—grown more cautious after greatly contributing to the $1.3 trillion owed by Third World countries, they are still willing to extend credit where borrowers seem responsible and want the funds to undertake projects that make economic sense. Again, it is domestic reforms, which will convince lenders that the money will be well spent and ultimately repaid, that is the key to economic success.

The Perverse Effects of International Lending Organizations

Unfortunately, this willingness by lenders to demand market discipline by borrowers has never been exhibited by the international lending organizations—the IMF, World Bank, and regional institutions. The multilateral development banks have uniformly favored government projects; the World Bank helped establish many of the failing state enterprises that it now says should be privatized; the Bank even continues to pour money into such organizations to "modernize" them, actually encouraging borrowers to resist privatization. The newly formed European Bank for Reconstruction and Development (EBRD), designed to lend to Eastern Europe and the USSR, is likely to be no different. Thus, multilateral loans may

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actually perpetuate the existence of money-losing enterprises that are draining away scarce resources from reform governments.

Particularly dangerous would be international lending to governments that have demonstrated no firm commitment either to democracy or market economics, such as Bulgaria and Romania. As Bauer points out, aid that may "do little or nothing for economic achievement and advance" may nevertheless "alleviate acute shortages," thereby helping to "avert total collapse and conceal from the population, at least temporarily, the worst effects of destructive policies." Which, "in turn, helps the government to remain in power and to persist with these policies without provoking popular revolt."

Promoting Market Reforms

Western governments committed to seeing glasnost and perestroika succeed, along with the reform governments struggling to help their people achieve a better life, need to focus on promoting market economic reforms. The general exhilaration over the movement toward political freedom is justified, but, as Bauer rightly points out, is not enough. To prosper, and for democracy to firmly take root, reform governments must replace their failing command economies with free-market systems. For the reasons cited by Bauer this is no easy task. Opposition to the market and resentment of a system that allows failure as well as success is strong even in the industrialized West; not surprisingly, there will be powerful forces against change in former command systems.

What can the West do to help reformers in the USSR and Eastern Europe succeed? Bauer correctly points to lowering trade barriers. America's professed policy of promoting development in the Caribbean, for instance, has been hobbled by the imposition of sugar quotas to protect domestic interests, which has blocked access to the most obvious market for the region's most important agricultural crop. It is critical that the West not respond to reforming governments in Eastern Europe and the USSR in the same way. By offering markets for products, the industrialized nations can best assist the development of efficient private sector industries elsewhere in the world.

More controversial is Bauer's support for narrowly targeted foreign aid. Bauer rightly warns that official transfers are more likely to hinder than advance liberal economic policies. However, he suggests that aid that helps reduce serious shortages, especially of imports, "might secure the survival of market-oriented reformist governments."

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In theory, Bauer's argument has much to recommend it. Official transfers might promote the shift to a market economy if the following conditions were present: (a) the government is "irrevocably committed to promotion of the market economy" and would be likely to collapse without aid because of the economic problems left over from the previous command system; (b) the aid is administered by people in sympathy with the move to a market economy; (c) the donor is willing to terminate the transfers if the recipient backslides; (d) the assistance is in the form of grants rather than loans; (e) the donations are bilateral rather than multilateral; and (f) the transfers are temporary.

The practical problems in implementing this theoretical policy, however, are enormous. How do we know that the government, which may incorporate different parties and factions and may be beset by powerful institutional resistance and special interest pressure, is "irrevocably committed to promotion of the market economy?" How do we judge the likelihood of a collapse without aid? (Poland, for instance, seems to be moving in the right direction despite not having received the levels of aid that it had initially requested.)

Where do we find aid administrators who support market reforms? How do we convince government officials to admit failure and cut off assistance—something neither bilateral nor multilateral officials have ever proved very willing to do—if the reformist government falters? And how do we overcome a problem acknowledged by Bauer, namely, the tendency of programs to be self-perpetuating? The Marshall Plan did end, but the scope of government and power of interest groups have both greatly expanded over the last four decades. And although the evidence is overwhelming that American transfers to poor states have done nothing to promote overall development, the programs continue.

Indeed, an equally serious, but more subtle, problem is the ability of special interests and bureaucracies to twist even well-intentioned programs to their own advantage. External aid, for example, has been tied to the purchase of U.S. products, and monies are almost invariably allocated to advance perceived U.S. political interests. Trying to implement Bauer's theoretically well-conceived assistance program would risk creating all of the deleterious effects that he so eloquently catalogues elsewhere in his paper.

Debt Relief

Interestingly, the one form of "aid" that might have the least perverse impact on reformist governments is the one dismissed out of

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hand by Bauer—debt relief. He worries that it would reward the "profligate," yet the debt forgone would have been accrued by ousted Communist regimes, rather than the new democratic governments. Contrary to his argument, there is nothing inconsistent with Western governments agreeing not to demand payment on debt amassed by illegitimate Stalinist systems and market reformers guaranteeing property rights and providing for restitution to individuals of confiscated assets. And a one-time debt write-down or forgiveness would not provide more power to politicians and bureaucracies, subsidize statist economic policies, or have most of the other ill-effects of official financial transfers.

Conclusion

Bauer's message is an important one, and it should be heeded by those in the West who want to assist and those in the East who have the responsibility for implementing needed reforms. Official aid transfers would be more likely to hurt rather than help. Instead, reformers need to recognize that the only way to create the conditions necessary for self-sustaining economic growth is to move toward a market economy as fast as possible.

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HALF OR FULL REFORM?

Oleg T. Bogomolov

The Need for Radical Reform

What is now going on in the Soviet Union and Eastern Europe can be best denoted by the word "revolution." Up to 1989, the administrative system underwent partial changes. The basic principles remained intact: the leading role of the party, domination of the state form of ownership, and the monopoly of Marxism in ideological life. The first attempt to restructure did not satisfy the society, nor did it resolve the crisis state. On the contrary, it only aggravated the situation.

While new structures and mechanisms have not been established, the old ones have become imbalanced. The very idea of reforms under socialism has become discredited, and faith in socialism's possible renewal has weakened. The people's confidence in the ruling clique has lowered drastically, and explosive material has been accumulating. As a dangerous malaise has been pushed deeper underground, the threat of its sudden and violent outburst has become increasingly likely.

In the autumn of 1989 the people's movement exploded in the GDR, causing a wave of detonations in Czechoslovakia, Bulgaria, and Romania. Changes that took many months and even years in Hungary and Poland were accomplished within several weeks. In light of these events, it has become clear that the existing system cannot be improved by partial perestroika; the system has fully discredited itself. It is necessary to form a qualitatively new social organization that would ensure true social and economic progress.

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The author is the Director of the Institute of International Economic and Political Studies (formerly the Institute of the Economics of the World Socialist System) in Moscow. He served in the Supreme Soviet of the USSR, where he was a member of the Committee for Economic Reform.

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This change requires disassembling the command-administrative system and liberating the people from dogmatism and utopianism in politics and from an ideology that has become the main brake in the way of progress. Both economic and political spheres equally need radical transformations.

There are many signs that the 1990s will witness the formation of a new social structure in the Soviet Union and Eastern Europe. The structure's principal features will be the following: a market economy with characteristically diverse forms of ownership and their equality (including private ownership), free enterprise and competition, broad democracy and glasnost, political pluralism including the existence of several parties and a parliamentary opposition, ideological diversity, reinstatement of liberty and humanism as universal human values, and openness to the outside world. The countries with a relatively high standard of living and with historical traditions of a market economy and democracy can transit—with international assistance and a rapid involvement into global political and economic relations—rather smoothly to the new social system. We can expect this transition within the coming decade. The transition period in multinational states, like the USSR, and in countries experiencing an acute economic crisis and a sharp collision of confronting forces will be inevitably more painful and longlasting.

The Speed of Transition to a Market Economy

How can we find the effective forms of democracy for a society that has no democratic experience? There is no relevant historical precedent of transition from totalitarianism to democracy, from an administrative-command economy to a market-oriented economy. The trial- and-error approach explains inconsistencies that will occur in the democratization and marketization of the Soviet Union.

Radical political changes are badly required to transform a frustrated centrally planned economy into a socially oriented market economy. The Soviet Union should choose its own way of transition toward a market economy, because Western experience is hardly applicable. The best option would be a gradual transition toward a socially oriented market economy while retaining basic democratic guidelines. Is that option possible? There is ample evidence to show how difficult it will be to avoid granting emergency powers to a government that would introduce market mechanisms and would implement unpopular measures in order to remedy problems of money circulation, prices, and the internal market in general. The

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question is whether the majority of people will support such measures.

One should not underestimate anti-reform movements and protests by large sections of the working class against hardships during the restructuring period. Attempts to use discontent and economic difficulties as an excuse for martial law are possible. Zigzags in the transition period, however, would not change the prevalent trend of development toward a market economy and democracy.

Debate continues as to what methods should be adopted to remedy the Soviety economy. It is very risky to liberalize prices on the consumer and wholesale market, to abandon the administrative system for distributing commodities that are in short supply, to make the currency convertible, and to remove restrictions on imports in the present conditions. There are huge disproportions in the economy, labor discipline is falling, and contracts are not honored. Nevertheless, Yugoslavia, Poland, and Hungary are taking the risks. Those countries prefer to speed up the process of transition to a veritable market economy, which they regard as the best way to stimulate economic activity.

Since the beginning of 1990, the economic situation in the Soviet Union has deteriorated rapidly: gross domestic product and industrial production decreased by about 5 percent, gaps widened between the money supply and the commodity supply in the internal market, and a serious deficit in the current-account balance developed in the external market. Taking into account the worsening situation, our leadership concluded that the transition toward a market economy must be accelerated.

Finally, after two months of rumors, conjectures, forecasts, stubborn questions, and noncommittal answers, in May 1990 the government presented to parliament its program for transition to a market economy.

The question is more than ripe—it is long overdue. Problems of inflation, financial improvement, and ownership have permanently figured on the agenda. On repeated occasions my colleagues and I have had to state our views before the Presidential Council, the Council of Ministers, and the press.

I can say, regrettably, that our proposals have not been heard. The program submitted for discussion cannot be seen as an effective transition to a market economy.

Preconditions for the Transition

To make market instruments operative, we must do the following: implement privatization of state ownership, guarantee equality of

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diverse forms of ownership, undertake price reform and liberalize prices to develop an appropriate market infrastructure that will reduce a huge budget deficit, abolish monopolies and create conditions for competition, reduce the monetary overhang by selling some state assets to stabilize the banking system and improve the financial condition of enterprises, establish a real exchange rate, and ease import control. We must also compensate losses experienced by low-income people during the transition period. In my view, the integrity of all these measures forms the basic preconditions for transition to a market-type econony.

Flaws in the Government's Program: A Plan-and-Market Hybrid

After reading the governmental proposals, I have the impression that whatever the government's idea of the market economy is, it is a kind of plan-and-market hybrid.

A market economy implies freedom to choose the seller and buyer. But why then does the centralized supply system (*Gossnab*) remain? A market means a mechanism for establishing equilibrium and, hence, the corresponding prices and self-regulation. But these mechanisms are almost invisible in the program. A market economy presumes that capital, land, housing, and labor become market commodities. Is this type of market economy in question? I strongly doubt it. Rather the question is one of a tailored commodity and consumer market, only the rudiments of which we have had so far. The market implies free competition and restrictions on monopoly, some elements of which are mentioned in the program, but no clear picture is seen here either. The accent on regulation essentially cancels all these freedoms.

For the sake of this quasi-market, we have been asked to bear immense sacrifices and to resign ourselves to what essentially amounts to a twofold increase in prices. The government says that it is opposed to withdrawing money through a currency reform. In the future, it is true, the government has promised to protect the population's deposits by raising the interest on them to between 4 and 9 percent. But inflation is already above this level.

I conclude that the presented program is purely fiscal in character and contains something that largely betrays its objectives: preserving the existing system. It puts all the costs, including those linked to the government's mistakes, on the population.

But this is only part of the problem. The program also has a built-in mechanism for inflation, namely, a system of indexation and compensation. Workers will have to be paid largely at the expense of

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enterprises, but enterprises will build these costs into their production costs, and hence into prices. The result will be the classical spiral of inflation.

It is impossible to improve the economy without abolishing the budget deficit, but it keeps growing. Today the deficit is as high as 100 billion rubles. The operation that was carried out to reduce the deficit by having recourse to empty loans from the enterprises can be regarded as no more than self-delusion. The deficit may rise to 150 billion rubles by the end of 1990—and no feasible solutions have been offered.

Perhaps the most important element lacking from the proposed program is an answer to the pivotal question: What will the incentives for labor amount to? The program defines the key feature of the incentive system as the increase in value of each worker's workplace. But what does this mean? Without a housing market and with the existing system of domicile registration, the program looks exactly like feudalism.

What is labor's incentive if we have just introduced a patently anti-market tax on people's incomes? This progressive tax portends not only an excessively steep scale, but also tax discrimination of individual, entrepreneurial, and cooperative activities. The tax was pushed through parliament on behalf of the government itself, which now proposes the same draconian taxes, only this time not on citizens' incomes but on enterprises' profits. When the profitability level reaches 30 percent, the whole of the "superprofit" is withdrawn into the budget. Where are the incentives? Who, under such conditions, will fill our market with goods and services? Most likely we face not merely the absence of a mechanism of incentives, but rather the imposition of a mechanism of anti-incentives. Moreover, people are getting caught under a double burden: growing prices on the one hand, and the impossibility for people to make money or to compensate for soaring prices with their work and initiative on the other. Increased prices will be more or less acceptable for people when they earn additional money through overtime, cooperatives, and new jobs in the private sector.

Lastly, complete uncertainty remains regarding transformation of ownership. The problems of privatization and freedom for producers have not been worked out; such mechanisms are either nonexistent or very doubtful.

It is proposed, for example, that housing should be redeemed in 10 to 15 years. The same with shares in enterprises, stores, and other trading facilities. I do not say that redemption is generally

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impossible; yet I believe our citizens must be given their share of property not only through sales, but also in other ways.

All the talk about poverty notwithstanding, our country is sufficiently rich and the state possesses an immense amount of property. But people have been alienated from this property. We must return at least part of it to the people. Everyone has a share in national wealth. Not only is it advisable to think of how to transfer property to everyone, but also it is exactly now (as we pass over to a market economy) that such a decision would be particularly meaningful. People must have the right to sell their share of property, mortgage it, or to use it for obtaining credit. This right to property is important because the market cannot operate effectively without proprietors. Besides this, owning property could really protect people against soaring prices and inflation and could do this much more dependably than the compensating increments to wages in rubles, which are modest in size and empty in content. It may be worthwhile to make land privately owned by young families, or to give people housing, transport, production premises, and so forth for a very low price.

I believe that today the government has opted for an impasse-like road of transition to the market. All signs point out a desire to combine extra economic coercion with the market. At first, there will be more administrative control and less market, but then we will have less administrative control and more self-regulation. But a hybrid cannot work: The Hungarians, Poles, and Yugoslavs have attempted to make a hybrid work, but the result has been the same.

Other Roads to Reform

Is there a different way out? Of course, there is; rather, there are two. The first is to cut the entry time to a minimum, to jump into a market economy all at once while simultaneously freeing practically all prices from control, that is, by resorting to what has become known as "shock therapy." As I see it, this road does not suit us.

The second course is to develop the market sectors in the economy by beginning primarily with the agrarian sector and to grant real freedom to the producer in developing production, establishing relations, and choosing partners. There are other sectors that are the most responsive to economic freedom and that quickly yield returns. Regrettably, the government's program again proposes developing agriculture on semi-feudal principles by introducing the tax in kind or, rather, by retaining the same state order. We must also take advantage of our public property and use it for the benefit of all people. The state should not behave like a dog in a manger: it must

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share this property, thereby making the transition to the market—with its inevitable liberalization of prices—easier for people to endure.

What the government's program has managed to achieve, with its call for a one-shot increase in prices, is an unprecedented buying spree as people rush to buy existing goods before the administered rise in prices. Things should not be done this way; serious reforms require thoughtful actions not hasty programs such as the government has prepared. The government's program is simply not credible. A government that comes to the ruins of an economy and says, "There is nothing doing. Let us build together. Let us strain ourselves," has a right to call on the poeple to make sacrifices. But when the call comes from a government that has itself taken part in bringing about economic dislocation, that call for sacrifices cannot have a convincing ring.

The government's proposal to carry out a referendum on the question of price liberalization seems absurd to me. The population's attitude toward this reform is absolutely clear. People will say "no," and the government will have to resign. Why then organize a referendum? Is it because some officials think (and hope) that a "no" to the price hikes will signal a "no" to the very idea of transition to a market economy?

After a lively discussion the parliament refused to approve the governmental concept of transition to a regulated market and instructed the government to submit on September 1, 1990, a revised concept and a new set of reform measures for implementation.

Will yet another attempt to present a plan of marketization be satisfactory? Many signs indicate that there is a very strong inclination to a half reform. Because of ideological prejudices and indecision, the government is reluctant to allow private ownership of land and other means of production, to provide the citizens with assets as a result of a consistent and fair privatization, to abolish the ministries, and to radically reform the state finances and banking system.

Of course, the transition from totalitarianism to democracy and from a command economy to a market economy cannot be effected painlessly. The burden of problems accumulated over decades is still very heavy. But many difficulties could have been avoided if miscalculations had not been made in the concept of perestroika and its practical realization, and if we had not seen inconsistencies and indecision.

We began to introduce market principles and the self-financing of industrial enterprises without the prior formation of the necessary environment: a genuine wholesale-trade market, full-value money, sound price and banking systems, and appropriate tax and credit

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regulations. As a result, the reforms did not get off to an effective start but created additional inflationary pressures.

It would have been wiser to have started from the other end—agriculture—with the emancipation of the agricultural producer from bureaucratic control and with giving the producer freedom of economic activity on the land. This emancipation would have called for leasing the land or transferring possession to family and cooperative farmers, together with gradually reducing the obligatory deliveries of agricultural products to the state and replacing that obligation with a system of free trade.

Instead of taking resolute measures to control the money supply and to balance supply and demand in the economy by a transition to a severe deflation policy, we continue inflationary policies. We amass expenditures for social needs, cross huge indebtedness of collective and state farms, and subsidize loss-making enterprises when we should cut spending on other budget items. The absence of a true monetary system that provides genuine purchasing power that is freely convertible into goods and, later on, into foreign currencies calls into question the entire economic reform in the country.

A Rule of Law

The political life of society should allow for the creation of institutions for self-regulation and self-correction of the economy and for a trouble-free manifestation of its laws. There needs to be an improvement in the Soviet legal system. A rule of law needs to be established so that investors, workers, enterprises, and individuals can count on fair rules of the game and can foresee the consequences of certain economic decisions. One of the most important tasks will be to define in unambiguous terms the permissible forms and limits of political intervention in the economy. We are still at the very beginning of the road in this direction.

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Gradual Versus Comprehensive Reform

William A. Niskanen

Oleg Bogomolov has made an acute analysis of the problems of the Soviet economic system and of the partial, tentative, and noncommittal measures to restructure this system during the past five years. And he has concluded, I believe correctly, "that the existing system cannot be improved by partial perestroika." Four of his insights, I suggest, are especially important.

Positive Reform Measures

First, the steeply progressive tax rates on labor income and enterprise profits limit both the incentives for increased output and the willingness of the population to accept the necessary price reforms. In American terms, measures to improve the "supply side" of the economy are a necessary component of an effective economic reform.

Second, the Soviet Union has a huge amount of assets but little capital, primarily because individuals and enterprises do not have the opportunity to reallocate these assets to higher value uses. A comprehensive privatization of state property, which is presumably owned in the name of the people, is the necessary first step to create a capital market. Moreover, as Bogomolov correctly observes, the individuals and enterprises that receive this property must have the right, in turn, to sell it or to borrow against it.

Third, at some stage, the package of economic reform measures must be subject to approval by democratic processes but it is a mistake to subject individual measures, such as the necessary price reform, to a referendum. This is a controversial issue but, I suggest, Bogomolov's position on this issue is correct.

Finally, I wish to reinforce his conclusion that "one of the most important tasks will be to define in unambiguous terms the permissi-

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The author is Chairman of the Cato Institute and a former member of the President's Council of Economic Advisers.

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ble forms and limits of political intervention in the economy." The constitution of a free people must define the island of governmental powers in the ocean of individual rights. The Soviet Union is now best described as a set of islands of individual rights in an ocean of governmental powers.

A Comprehensive Reform Strategy

My one major disagreement with Bogomolov is his recommendation for a gradual industry-by-industry reform, beginning primarily with the agricultural sector. There are two problems with this approach, one economic and one political. Each successive reformed sector would still face artificial prices and state controls on the necessary inputs from other sectors yet to be reformed. And the gradual approach would allow the opponents of reform to concentrate their opposition on each successive step. To illustrate my perspective, let me make a distinction between a comprehensive reform strategy and a "big bang" approach. A comprehensive reform strategy *initiates* all of the necessary reform measures at the same time but allows each measure to proceed at its own appropriate pace. A "big bang" approach, in contrast, attempts to maintain this same schedule for each of the reform measures, an attempt that I believe cannot succeed.

Many years ago, Friedrich Hayek demonstrated the difficulty of maintaining a credible gradualism in economic policy, because the population cannot discern whether each step is part of a longer series of steps to which the government is committed or is only a tentative step that may later be reversed. In the latter case, the response of the population would be much more cautious, slowing the effects of the reform.

We do not have a good theory or much evidence that bears on the appropriate *sequence* of reform measures, so some errors will surely be made. A comprehensive strategy that jointly addresses all of the reform measures, however, would minimize the costs of these errors.

A comprehensive reform strategy also puts pressure on all of the bureaucracies and opponents of the reform at the same time, reducing their opportunity and incentive to collude to oppose each successive step in a gradual reform strategy.

Lessons from New Zealand

In conclusion, I would like to offer five lessons from the most ambitious economic reform of the 1980s—that by the Labour govern-

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ment of New Zealand, as summarized by a senior representative of that government:

1. A country's crisis also creates a "window of opportunity" for fundamental change.
2. Electorates are more sophisticated about the importance of reform than most politicians believe.
3. Comprehensive reform is clearly easier than piecemeal reform.
4. Establish credibility early by choosing the first reform measures wisely, demonstrating that reform works.
5. Once a government is committed to reform, it can never move too fast to achieve it.

Those who wish to transform the Soviet system should pay special attention to Roger Douglas, the architect of the New Zealand reform.

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Individual Rights, Democracy, and Constitutional Order: On the Foundations of Legitimacy

Roger Pilon

Introduction

After more than 70 years of Communist rule, the people of the Soviet Union today face an enormous challenge—to make the transition to freedom. Never in history have so numerous and diverse a people as those who live in today's Soviet Union undertaken so fundamental and difficult a transition as is envisioned by the move from a planned to a free society. Were the transition going in the other direction, it would be relatively easy, of course; for as theory and history demonstrate, socialism is brought about simply by taking what is privately held, from land to labor, and putting it under public control. Getting out of socialism, however, is much more difficult, not least because, over time, many of the conditions that characterized the pre-socialized order—such as a distribution of private holdings—and enabled that order to function and evolve—such as a system of private law and the culture that sustains it—have been all but destroyed. It will not be easy to revive those conditions or to create them anew. Yet for all the difficulties, the transition must be undertaken; the chaos and suffering that are the inevitable products of the planned society must be brought to an end.

Important as it may be to focus on the difficulties, however, it will be even more important to keep in view the prospects that lie ahead

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The author is a Senior Fellow and the Director of the Center for Constitutional Studies at the Cato Institute. He was a senior official in the Reagan Administration, serving as Director of the Asylum Policy and Review Unit of the Justice Department and Director of Policy for the Bureau of Human Rights and Humanitarian Affairs at the State Department.

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for the peoples of the Soviet Union. And here we need to recognize that in many ways these are exciting times. For the first time in generations, after all, Soviet citizens can speak openly about their future. Things are possible today that were undreamed of only a few years ago. Recall that Germany and Japan lay in ruins and under occupation at the end of World War II, yet within a generation they were prosperous nations. That potential is here today in the Soviet Union. It will take work and dedication, of course. But above all, it will take a vision on the part of the people and their leaders of where they are going, how they are going to get there, and, most important, why they are undertaking so arduous a journey.

Underlying all the practical questions that surround the transition, then, are these deeper questions, questions of first principle. And none of these is quite so pressing as the question of legitimacy. For the events of the past year throughout the socialist world signify nothing so much as a crisis of legitimacy. As the Berlin Wall, the starkest symbol of that crisis, came crashing down upon the illegitimate regimes of the East, the thirst for freedom and a greater measure of legitimacy grew all but palpable. To have seen the crisis unfolding, however, is not to have witnessed its resolution. Rather, we have seen simply, and again, that man is a moral creature: In his political no less than his personal life, he yearns for legitimacy. Yet the gap between that yearning and its realization is yawning still, not only in the East but, to one degree or another, throughout the world, including the West.

This question of legitimacy, then, will be my principal concern here, for upon it turns everything from prosperity to peace. Indeed, without a better understanding and appreciation of its foundations, we are doomed to a constant struggle in its name—either the intense struggle we are witnessing now in the East, or the less-intense but no less-enduring struggle that has come to be the political life of the West. Toward minimizing that struggle we must recognize, properly relate, and then institutionally secure the three elements that constitute the foundations of legitimacy—individual rights, democracy, and constitutional order. And we must ensure that the order that is thus secured, if it is to endure, is broadly understood and appreciated.

Because my thesis is in several parts, each of which I want to develop to some extent, and because in places it is more abstract and abstruse than I wish the subject required, it may be useful to summarize it here, at least in conclusory form. In brief, the move from rule by the party to rule by the people, the beginnings of which we are seeing throughout the Soviet Union, is absolutely essential if legitimacy is to come about. But that move in the direction

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of democratization gets us only part of the way toward legitimacy, for rule by the majority, which is the practical manifestation of rule by the people, can be every bit as despotic and illegitimate as rule by the minority. To complete the process of legitimating power, therefore, the next step must be taken, toward rule by the individual, or self-rule, which in truth is a move toward privatization. The move toward privatization or self-rule, however, can never be fully completed, for reasons both practical and theoretical that I will discuss shortly; taken to its limit, in fact, such a move would amount to the elimination of government. Nevertheless, that limit can be approached through the creation of constitutional mechanisms that recognize, first, that legitimacy is grounded from the start in the individual; second, that only those powers that belong legitimately to individuals can be legitimately transferred to government; and third, that the procedures for making such transfers are fraught with difficulty, all of which leads to the conclusion that only limited government—government that leaves as much as possible to the private sector—can claim plausibly to be legitimate. Whether such limited governments will be seen to be legitimate by those living under them is a different and a difficult question, which I will take up next, then return to later.

Legitimacy as Subjective Acceptance

As these introductory remarks should already have suggested, we may talk about legitimacy on two quite different levels or from two quite different perspectives. On one hand, the philosopher may analyze the idea and its elements from the perspective of reason or moral rationality, attempting to justify his conclusions with reference ultimately to the theory of moral or natural rights. That will be my principal concern here. But on the other hand, the social scientist or the political leader may look at legitimacy empirically or operationally.[1] In so doing, the closely related idea of "acceptance" looms large as an empirical or operational criterion for legitimacy. On this approach, the fact that a regime is or is not accepted by the people living under it will tend to distinguish legitimate from illegitimate regimes. I emphasize "tend," however, for "acceptance" can serve this function only in a very crude way. That many in this century have fled from socialist regimes while many more have sought out democratic capitalist regimes doubtless says much about the legitimacy of those regimes, at least as perceived by the people in motion;

[1]This approach is also found among philosophers of law working in the tradition of legal positivism. See, e.g., Hart (1961).

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for when people vote with their feet, they speak volumes. At the same time, many more have not fled their homelands, however oppressive the political conditions there. Thus, any extrapolations from such gross evidence of acceptance to assessments about legitimacy can be only suggestive, yielding crude and sometimes even misleading measures of legitimacy.

Nevertheless, this subjective criterion of legitimacy, as we might also think of it, does tend to restrain the actions that political leaders might take, which is why it cannot be dismissed. Even if they discern a more legitimate order, that is, an order reflecting rational or objective criteria of legitimacy, it does not follow that political leaders can bring such an order about. If a substantial or otherwise important enough portion of the population thinks the proposed order illegitimate, education, persuasion, and leadership may be required before those subjective perceptions of legitimacy can be brought into harmony with a more objectively grounded sense of the idea. This tension between two quite different senses of "legitimacy," grounded on different criteria, constitutes a very old problem, of course, but a very real one as well, both in the East and the West. And it is a problem that cuts both ways: Sometimes the leaders are right and the people wrong; sometimes it is the other way. But none of this can be determined with any confidence short of a more rigorous and systematic approach to "legitimacy," to which we now turn, after which we will again take up this inherent tension in the idea.

Objective Legitimacy: Clarifying the Idea

To come to a better understanding of the rational foundations of legitimacy, we need at the outset to notice a pair of ambiguities that surround the use of the term. First, we may speak of legitimate governments or of legitimate governmental powers: They are not the same, for a legitimate government may exercise illegitimate powers, and an illegitimate government may exercise legitimate powers. And second, we may speak of legal and of moral legitimacy, which again are not the same. Let me develop those two points in order.

Legitimate Government and Legitimate Power

To the extent that they give reasons for what they do, all governments, or government spokesmen, can be said to seek legitimacy. To give reasons is to attempt to explain, at least, and that slides easily into an attempt to justify, which is an attempt to argue the legitimacy of what might otherwise be thought illegitimate (Pennock and Chapman 1986). But legitimacy can be said to attach to governments as

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such as well as to the policies, rules, and actions of governments. At the international level, for example, it is the government itself, as an institution, that seeks legitimacy through recognition by other governments. Because the legitimacy that arises from such recognition is not my principal concern here, I will concentrate instead upon the legitimacy that may arise from the relationship between government and its subjects. In so doing, however, I will focus not so much on the legitimacy that attaches to governments as such, which is rooted in their origins (Wolff 1970), as on the legitimacy that may attach to the various actions of a government. If governments, like people, are known by their actions, and if actions, in the end, are what count for those subject to them, then this is the proper focus for our attention.

Legal and Moral Legitimacy

Let us turn now to the second ambiguity that surrounds the idea of legitimacy, to the distinction between the legal and moral senses of the idea. In its narrower, legal sense, "legitimate" is simply a synonym for "legal." Used in its legal sense, that is, a government's action is said to be legitimate if it is legal, if it conforms to the system's criteria for legality, whatever those criteria may be.[2] In this sense, legitimate actions are distinguished from *ultra vires* actions. This narrower sense of "legitimacy," however, even as it entails an occasional venture into normative terrain, as in systems that permit judge-made law, is not the sense we ordinarily intend when we say that a government is legitimate or that some government action is illegitimate. What we mean, rather, is to make a *moral* claim. We mean not simply that the government satisfies or its action fails to satisfy some narrow criterion of *legal* legitimacy but that it satisfies or its action fails to satisfy *moral* criteria. Moreover, when *governments* make claims about the legitimacy of their actions, they especially cannot be thought to be making a mere legal claim. To suppose otherwise would be to suppose that in thus characterizing their actions, governments are saying that those actions are merely legal, but not necessarily moral. That interpretation simply strains credulity. To so intend would defeat the whole point of a government's claiming legitimacy for itself.

Ordinarily understood, then, the claim of legitimacy points precisely to the nexus between law and morality, which is why it plays

[2]Here, again, this is the proper province of the legal positivist, who discerns what those criteria may be—the criteria that distinguish law from law-like phenomena, such as mere rules of ethics or etiquette—then whether various indicia of law or legal power do in fact conform to the criteria.

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so central a role in political discourse. When governments wrap themselves and their actions in the cloak of legitimacy, they are claiming, by implication, that their actions are not simply legal but moral as well. They are invoking moral criteria to justify actions otherwise thought at least to be legal. Moreover, and more precisely, they are saying that in being legitimate, in being moral, those actions are performed *by right*, whereas an illegitimate action is one that the government has no right to perform. At bottom, then, questions about political legitimacy reduce to questions about moral rights. Legitimate government actions are performed not simply by legal authority but by moral right. That, at least, will be my concern here, to determine when those claims about the legitimacy of various government acts can be justified not simply by legal but, more deeply, by moral criteria.

Early Substantive Approaches to Legitimacy

Natural Law: Deontological and Teleological

How, then, have governments sought to argue these claims about the legitimacy of their actions? Here, a very brief historical review will be useful. In the pre-modern era the approach to political legitimacy was generally substantive, not procedural. Two main lines, in the natural law tradition, can be discerned. The first was deontological and was rooted specifically in theological considerations. The "higher law," to which positive law was said to conform, was the command of God. Under this version of higher law, the duties of those subject to the law were correlated not to the rights of other subjects but to the commands of the sovereign, which in turn were the temporal manifestations of divine commands. Legitimacy was thus a straightforward function of the correspondence of positive law to divine law.

The second line of argument in the natural law tradition was teleological, rooted in a conception of man as a purposive agent with certain natural ends, the realization of which it was the function of positive law to enhance, while prohibiting the pursuit of certain unnatural ends. Stemming at least from Aristotle, this view found its greatest exponent in St. Thomas Aquinas, who argued that man is a social animal who desires to live in common with other men in order to satisfy his needs and wants, which implies that he ought to cooperate with those others for his own, their, and hence the common good. Legitimacy, on this view, was a function of whether the ends sought to be secured by positive law were indeed consistent with

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our natural ends and whether the means entailed by that law did in fact serve to secure those ends.

Epistemological Uncertainty and the Rise of the Individual

The problems that surrounded those two substantive approaches to legitimacy were several, but they all related, in one way or another, to epistemological uncertainty. Theocratic deontologists had difficulty explaining to nonbelievers, for example, why divine law should serve as a model for positive law. And even among believers, the foundations of belief proved inadequate to resolve differences over the content of divine law; disagreements at the theological level thus devolved into disagreements at the secular level. Those problems, arising from inadequate epistemological foundations, had their counterparts among the teleologists as well. For the idea that man has a certain nature and certain natural ends, while ostensibly more "scientific" than the theological approach, was simply too general, too subject to disconfirmation when made more specific, and too circular to command universal acceptance. Moreover, the strategy of the argument, as David Hume later observed, involved a straightforward inference from factual assertions about the nature of man to normative conclusions, a move the canons of logic could not support (Hume [1739, 1740] 1978, pp. 469–70).

With both those approaches, however, a sense of unease arose from their authoritarian character, for they had about them more than a trace of order and legitimacy imposed from above. By implication, of course, that unease would arise whenever there was dissension from the universal or dominant view, for then the correctness—and the legitimacy—of the overarching view would come into question. That unease could only grow, however, with the rise of the individual through the late-medieval and early-modern era. As the place and importance of the individual grew in our consciousness, the difficulties of deriving legitimacy from overarching, seemingly authoritarian theories grew as well. Nor was it the moral quality of the overarching rule that was the real problem: Good rule as well as bad, beneficence as well as maleficence proved inadequate to the challenge. For if the individual was truly the beginning—the fundamental building block—and the end of society, only *self*-rule would do. There, precisely, was the locus of political legitimacy: not in *good* rule from above but in *self*-rule from below. For only so would the wish—indeed, the right—of every individual to rule himself be respected. Legitimacy and self-rule forevermore would be entwined.

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The Soviet Regression

Well, not quite. This brief history of the demise of pre-modern attempts to derive and impose legitimacy from above does not end, of course, with the emergence of the individual in the West and with the grounding of legitimacy in that individual. Perhaps no one needs to be less reminded of that than the Soviet citizen, who for 70 years and more has had a conception of legitimacy imposed upon him from above, by the party, the vanguard of the proletariat, the leading and guiding force of Soviet society, armed with Marxism-Leninism, which imparts a planned, systematic, and theoretically substantiated (read, "legitimate") character to the struggle for the victory of communism. Soviet citizens will recognize there the language of Article 6 of their constitution (Ramundo 1978). But I could have drawn from Marx or Lenin or a thousand and one other theoreticians to show that, far from a continuation of the liberal tradition that emerged in the West in the 17th and 18th centuries, the model of government that was imposed on the peoples of the East from 1917 onward was a throwback to the *ancien regime*. It was a top-down, not a bottom-up, model of legitimacy, with the party standing in the place of the king. As such, it suffered all the problems that the earlier models had suffered—and many more besides. Most important, for our purposes, it needed only one person, one individual, asking "why?" to bring the entire edifice into question. As with the *ancien regime*, there has been no shortage of such dissidents. And as before, because their question threatened to bring the whole edifice crashing down, they could not be tolerated. But neither could they be silenced, until today they are everywhere, and everywhere the edifice is in ruins. It is time to build a new structure, this time from the bottom up.

Modern Substantive and Procedural Approaches to Legitimacy

The question the dissidents asked—the question that every dissident has asked from the beginning of time—can be stated generally and simply. Indeed, it is the fundamental question of political philosophy: By what right does one person have power over another? Calling for a warrant, for a justification for the exercise of power over another, it is a question about authority, or power that purports to be legitimate. At bottom, it is a question about moral equality, for it asks for the justification for unequal authority. Let me state here and now that no one has ever answered the question satisfactorily—in a way, that is, that gives confidence that political power has been deeply justified. Nevertheless, democratic theorists have come closer than

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any others. Let us see how they have done that, and where they have failed. For in their failure they have charted a path toward legitimacy, which we would all do well to follow.

The Substantive Starting Point: The Private Realm of Individuals and Individual Rights

Democratic theory begins, as it must, by recognizing the right of the individual to rule himself and himself alone (Locke [1689] 1965, para. 13). The importance and power of that starting point cannot be overstated. For if the locus of legitimacy is in the individual and in his right to rule himself, then rights, far from being grants from the state, are already inherent in the individual, quite independent of any recognition by the state or even any existence of the state. Indeed, whatever rights or powers the *state* has are given to it by the individuals who create it in the first place; for individuals and their rights are both temporally and logically first, states second, with their characteristics, including their rights or powers, derivative (Nozick 1974, p. 6). That, precisely, is what the American Founders meant when they wrote, in the Declaration of Independence, that to secure these rights—namely, the rights that pre-exist the state—governments are instituted among men, deriving their *just* powers from the consent of the governed.

We will take up that creation and derivation in a moment. For present purposes, however, it is crucial that we notice certain features of the pre-government world, or the theoretical state of nature as it is commonly called. In particular, we need to recognize that it is not a lawless world (Locke, para. 6). On the contrary, a world in which individuals enjoy the equal right to rule themselves, and themselves alone, is a world ruled by the natural law—not the theological or the teleological natural laws of old, which were rooted in the epistemologically indeterminate realms of aspiration and value, but the modern natural law of reason (Locke, para. 6; cf. Gewirth 1978), the theory of natural rights, rooted in the intersubjectively verifiable idea of *property*, broadly understood, as John Locke put it, as denoting "lives, liberties, and estates" (Locke, para. 123). So important is this idea of property—the property we possess in our lives, our liberties or actions, and the things we acquire either by original acquisition or through contract—that property can be said to constitute the very foundation of the private realm (Pilon 1983). It is not for nothing that Marx took property as his principal target. Destroy the foundation of the private realm and you destroy that realm.

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Yet it is in that private realm that individuals can be said to be truly free, free to plan and live their own lives, by their own values, however wise or foolish those values may turn out to be. In the private realm individuals are free to enjoy their general rights to life, liberty, and property, and all the countless manifestations of those rights. And they are free to join with others, with the consent of those others, to create all the special rights and obligations that contract and association enable, from marriages to businesses to everything else we have come to call civilization.[3] Finally, they acquire legitimate power over others only if those others have consented or if their general or special rights are violated by those others, as by torts, crimes, or contractual breaches, and only, in the case of violations, to the extent necessary to be made whole again. This, in a nutshell and at its best, is the private common law of England and America as that law evolved over the centuries. It is a law derived ultimately from principles of reason; a law rooted in the idea of individual autonomy, as defined by property and contract; a law reflecting the rights of individuals, rights we create government to secure (Pilon 1979).

Before taking up that creation, one final issue needs to be raised, namely, that although life in this theoretical state of nature may be free, it may also, as Thomas Hobbes observed, be solitary, poor, nasty, brutish, and short. The reasons have been well catalogued in the literature. They all have to do, in one way or another, with uncertainty (Nozick 1974, pt. I). For although each of us enjoys the executive authority in the state of nature—the second-order right to secure our first-order rights and, if they consent, the first-order rights of others as well—there can be uncertainty, among other things, about what our first-order, substantive rights are; about what our second-order, procedural rights are; and about whether our conceptions of those rights conform to the conceptions of others. Life without social institutions to settle such uncertainties might prove difficult, at best.

Accordingly, theorists of the classical liberal tradition proposed procedures through which the familiar institutions of government might be established, institutions that might in turn resolve such uncertainties by declaring the law, resolve complaints about violations of law by adjudicating disputes, and pursue whatever else of common interest might usefully and legitimately be pursued through such public institutions. The question we need to ask,

[3]This distinction between general and special rights and obligations can be found in Hart (1955).

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however, is whether, through such procedures, the legitimacy that characterizes self-rule can be preserved. Can we move from the private to the public realm, from individual self-rule to group or collective rule and respect the individual right of self-rule, the locus of legitimacy, in the process?

The Procedural Path to Political Legitimacy: Does It Take Us There?

The modern path to political legitimacy has wound through the procedures of the social contract, of course, which is grounded in the idea of consent. For just as the individual in the private realm could authorize others to exercise power over him by consenting to that exercise, so it was thought he could authorize public officials to exercise power over him by giving his consent. More generally, the legitimacy of government itself was thought to be grounded in consent, as manifest by the ratification of a constitution that in turn authorized the government. If things were that simple, there would be no problems; but, of course, they are not that simple. In fact, they are much more complicated and problematic.

For present purposes, we will assume that the polity, or group in question, and the territorial issues are unproblematic—large assumptions, to which I will return shortly. So assuming, there is one version of the move from individual self-rule to group rule that is not a problem—the version in which all group decisions are made unanimously. By definition, unanimity preserves consent, but in a world of widely varying tastes, it is rarely if ever achieved. Accordingly, resort to majoritarian rule ordinarily follows, or to rule by some other fraction of the whole. But by itself, majoritarian rule cannot be legitimate, nor was it ever thought to be by the modern theorists; for whether the majority is 50 percent + 1 or 100 percent −1, the minority, by definition, has not consented. We have the *ancien regime* all over, with the majority standing in the place of the king, the minority in that of the subjects. No, what justified majority rule, on the modern theory, was prior *unanimous* consent to be bound *thereafter* by the majority or by some other fraction of the whole. That arrangement would legitimate political power—provided the prior unanimous consent could be shown.

There, of course, is the rub, for even in America, where we came closer to the ideal model than anywhere else, the debate continues over just who was supposed to have given that prior unanimous consent—the people or the states—and just how that consent could possibly have bound succeeding generations. The truth, of course, is that nowhere can we point with confidence to any deeply satisfying

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consent, not even in America. It simply did not happen in the way the theory requires, nor is it likely, for practical reasons, that it ever could have.

The last resort of the democratic theorist, therefore, is to point to so-called tacit consent: You stayed, therefore you have tacitly consented to be bound by the majority. Nothing in that argument limits it, however, to cases in which the majority rules; the argument could as easily apply to kings or to tyrants, purporting to make their rule legitimate too. Moreover, and more generally, the argument is patently circular: It amounts to putting the individual to a choice between two of his entitlements, his right to stay where he is and his right not to be ruled by another—this last being precisely the point that has to be justified, not assumed away.

We are left, then, with the unsettling conclusion that although democratic theory starts at the right place—with the individual—and points in the right direction—preserving legitimacy through consent—it is unable to carry out the latter burden; it is unable to preserve legitimacy as it moves from individual rule to group rule. Thus the state that emerges from such procedures has an ineluctable air of illegitimacy about it, as does everything that is done through the state—all of which suggests that out of a concern for legitimacy, for minimizing the forced association that the state necessarily is, as little as possible be done through the state, as much as possible be done in the private realm, where it can be done through free, voluntary association. On balance, it is perhaps better that we select officials and policies by majoritarian rather than by other possible procedures. But those procedures do not yield results that deeply satisfy our yearning for legitimacy, especially on those occasions when we find ourselves in the minority, under the burden of some particularly onerous majoritarian preference. On such occasions, which in the West are all too common, and increasingly so as majorities ask governments to do more and more, we yearn for a more secure foundation for legitimacy than is afforded by democratic process. And we yearn in particular for some institutional brake upon the illegitimacy that too often follows from the majoritarian process. That, among other things, is what a constitution should be—a brake upon democratic tyranny.

Constitutional Order: Securing the Private Realm

A constitution is a social compact through which the founding generation of a people who will thereafter live under the compact constitutes itself politically and legally. It is an instrument through which those people authorize and institute a plan of government.

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But in instituting a rule of law, the founders *ipso facto* put a brake upon the government they authorize—otherwise they could go straight to a rule of man and dispense with any instrument that locks some plan in place.

Ideally, then, a constitution authorizes the institution and institutions of government, establishes the rules of governance, and, most important, sets forth a vision to be secured through those institutions and rules. If any of those elements is inadequately crafted, the door is open for illegitimacy. Institutions or rules that enable power to be concentrated in public hands, for example, are anathema to individual liberty, as *The Federalist Papers* make clear. But above all, an inadequate or otherwise mistaken vision of the order to be secured—of the rights and obligations we have in the state of nature—will all but ensure illegitimacy.

Let me expand briefly on this last point. As we have just seen, because of the difficulties of satisfying the consent requirement, *all* acts of government, as well as government itself, have an inescapable air of illegitimacy about them. As the more candid of the classical liberals recognized, government, owing to its character as a forced association, is an evil, but, owing to the practical difficulties of enforcement in the state of nature, a necessary evil. Recognizing that *procedural* source of illegitimacy, which stems from the problem of authorizing government as such, we can still ask whether a given act of government is legitimate *substantively*—that is, whether that act, however dubious its procedural pedigree, would be legitimate if performed by individuals in the state of nature, although performed here by government. In general, when individuals come together to constitute themselves politically, insofar as they can be said to do so, they can be said to have a right to authorize government to do for them what they *themselves* would have an *independent* right to do—such as secure their rights in a state of nature. When they, or a majority among them, ask government to do what they have *no* independent right to do, however, then the government acts they "authorize" are twice illegitimate—from procedural *and* from substantive considerations. For how can individuals yield up to the state, to be exercised on their behalf, powers they do not have? Asked the other way, how can the state legitimately exercise powers that no individual could legitimately exercise in the state of nature? Since all powers the state legitimately has, if there are such, must be derived from the individuals governed—in theory, through their consent—how could the state have derived powers that were not there in the first place to be derived?

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Thus a substantive vision that authorizes forced transfers from one part of the population to another—the most common democratic wrong today—simply starts off on an illegitimate foot. For if it is wrong for *A* to take from *B* without *B*'s consent, however worthy *A*'s motive, how could it be right for *A*, as a government official, to do the same? It strains credulity, for reasons just discussed, to suppose that everyone standing in the position of *B* gave his consent to such a transfer in some original position, at the time of constitutional choice. In fact, because that original consent—the ratification that gets the constitution and the government off the ground and running in the first place—is so tenuous, so strained, yet legally binds not only everyone in the founding generation but all succeeding generations as well, it is absolutely essential that the vision thus secured be itself inherently legitimate. And the only vision that stands in that position is the vision that respects the right of every individual to plan and live his own life, free from the interference of others, including the government—a vision that has as its foundation the equal rights of every individual to life, liberty, and property. It is a vision that electrified the world when it was declared in 1776. It continues to inspire millions around the world today.

Bringing the Vision About

But none of this can be instituted or sustained without a substantial measure of popular support. We return, then, to our earlier discussion about the gulf that often exists between legitimacy as derived systematically from principles of reason and ethical analysis and legitimacy as perceived by a substantial or otherwise important part of a given population at a given time. Such a gulf is not inevitable, of course. In fact, the liberal vision just sketched, in which individuals are free to plan and live their own lives and government is limited to securing those rights, has a certain common-sense appeal about it, which should be understandable and even inspiring to people of ordinary interests and intelligence. Nevertheless, for reasons of history, experience, culture, and more, there will always be people who crave ever-expansive government, oblivious, indifferent, or worse to the perils inherent therein.

As noted earlier, to bring such people to a keener understanding and appreciation of the foundations of legitimacy, constant education and leadership are essential. But such efforts can go only so far: Human nature being as it is, there will always be divisions, as there were in America at the time of our founding. Eventually, a point will

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be reached where a decision has to be forced through. In America we were fortunate that the men who forced their vision upon us—for let us be candid, most of the rest did not have a vote at that time—had a vision that was largely correct. Other countries have not been so fortunate. Let us hope that when the time comes again for a portion of the Soviet people to force their vision upon the rest—for candor again requires us to recognize that the consent requirement can never be fully satisfied—those people will be substantial in number and, more important, will select their vision more carefully than heretofore has been done.

As these findings apply to today's Soviet Union, then, we may conclude that the move from party rule to democratization, which is already under way here, is essential if the conversion from top-down to bottom-up authority is to be effected. But that move, by itself, will not be enough to bring about a legitimate political order. More important is the move to privatization and self-rule—democracy's starting point—for only there, in that private realm, is legitimacy truly to be found. And that private realm must be secured to the greatest extent possible by a written constitution, a constitution that recognizes the rights of individuals to life, liberty, and property in all their manifestations—from religion to speech, press, assembly, commerce, due process of law, and all the other implications of those basic rights. Majority rule should be limited, in turn, to fleshing out the interstitial and gray areas of that otherwise rationally grounded common-law order, and to such other issues as are strictly essential to the public domain. Under no circumstances should institutions of government engage in commerce—not simply from considerations of efficiency but, more deeply, from considerations of morality, from a recognition of government's inherent character as a forced association. If the rights of individuals to plan and live their own lives are to be respected, commerce, and social life generally, must remain a matter of free, private association, with government serving only to protect those rights.

Jurisdictional Considerations

Those procedural and substantive considerations, pertaining to democratization and privatization respectively, need to be supplemented, however, by what might be thought of as jurisdictional considerations. Here we broach one of the most vexing issues facing the Soviet Union today: Over which people or peoples and over what territory is any new constitutional order to range? This is not a question unique to the Soviet Union, of course; Yugoslavia, Romania,

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Czechoslovakia, and even Canada are all among the nations of the world presently facing the issue. And it is an issue about which there is at once seemingly everything and nothing to say. The idea of "a people," with its language, culture, history, and identity stemming from and shrouded in the mists of antiquity, surely predates and prefigures the modern conception of constitutional if not legal order. At the same time, there is surely nothing written in stone about any present political configuration, no immutable principle that would be irretrievably lost if things should change—the more so if that arrangement is the minimalist one prescribed here. Where a more expansive and interdependent political order is under threat of disintegration, the inconvenience that would attend the demise properly belongs on those who have imposed or benefited from that order. Given the evolutionary and migratory characteristics that have ever marked the human race, however, the jurisdictional issues should probably be left to sort themselves out naturally, which in the end they will likely do largely from considerations of affection and efficiency. If ever there were an issue on which it should be left to the individual to decide what he should do and where he belongs, this is surely it.

But if legitimacy is ultimately substantive, as I have argued, and if it is grounded in the end in self-rule, then jurisdictional reflections should ordinarily lead to the recommendation that authority be kept as close to the individual as possible. That is not always the case, however, as is indicated by an example from the American experience, which may be relevant to the Soviet experiment. By the time the American Constitution was drafted in 1787, the 13 sovereign states that had declared themselves an independent people in 1776 had amassed, through their separate legislatures, a host of separate state statutes aimed at protecting local business and industry from competition from out-of-state firms, the net effect of which was to frustrate the free flow of interstate commerce by burdening interstate contracting. Here, if ever, was a case of local authority run amuck, not despite but because it rested closest to the people ruled, an influential portion of whom had used government for their narrow ends. In 1787, however, with the insertion of the Commerce Clause in the new Federal Constitution, which gave the *national* Congress the power to regulate commerce among the states, the logjam was broken, the local barriers came down, and the free flow of commerce resumed. With respect to jurisdiction, then, it may be necessary to go to a more remote level of authority to protect us from ourselves, as it were. Indeed, this is a particular example of a feature of constitutions generally: They are instruments in which we try to write in

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stone, for all time, what we may be unable or unwilling to write in sand for the moment.

But there is a second lesson to be drawn from the example of the Commerce Clause that is perhaps of equal or even greater importance, for it returns us to the substantive order and to the connection between a constitution and the order that flows from it. There can be little doubt, as the history that surrounds the Commerce Clause makes clear, that those who drafted the clause intended that Congress and not the states should have the power to regulate—or make regular—commerce among the states. The furthest thing from their minds was that Congress might use that power, however broadly drawn, *affirmatively*, to regulate, in the minutest detail, all manner of inter- and intra-state commerce and industry, making a mockery of the original purpose of the clause. Yet over the years, and over the past 100 years in particular, that is precisely what Congress has done, frustrating and burdening the free flow of trade in ways the Framers would never have dreamed (Epstein 1987). In drafting a constitution, therefore, it is imperative to be as precise with language as language permits, and to be mindful always of Lord Acton's dictum, that power corrupts, absolute power corrupts absolutely.

In conclusion, as I observed at the outset, however real and distressing the hardships of the moment in the Soviet Union, in many ways these are exciting times to be a Soviet citizen. The potential for freedom and, eventually, prosperity is also very real. Indeed, history may yet look kindly upon the peoples of this land and make of this generation the founding generation, the generation that at last made the transition to freedom.

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Liberalism, Marxism, and the State

Ralph Raico

Liberalism

The great transformation that is taking place today in east-central Europe and in the Soviet Union has led many people to reconsider the merits of an ideology once thought to be obsolete—liberalism. In the West, some have gone so far as to prophesy "the end of history." They argue that liberalism is on the point of becoming the sole ideology of any significance, so that soon the conflict of political ideas will cease to trouble mankind (Fukuyama 1989). Their conclusion appears highly unlikely, and, in any case, prophecy is not science. This paper deals with liberalism as it has been understood historically and considers its connection with a certain strand of Marxist thought—a strand that may well be much more important now than other elements of the Marxist tradition that have been emphasized in the past.

Liberalism has, of course, many meanings, and many different orientations have chosen to call themselves liberal. Without arguing the point, I wish to maintain that the most authentic and characteristic form of liberalism has been concerned with two things: first, expansion of the free functioning of civil society, and, second, and increasingly, restriction of the state's activity.[1]

Liberalism arose in the 17th and 18th centuries as Europe's response to monarchical absolutism. Where the monarchs by divine right claimed to control and direct all of the life of society, liberalism replied that, by and large, it is best to leave civil society to run itself—in religion, in thought and culture, and, not least, in economic affairs. The liberal slogans of *laissez faire*, *laissez passer*, and *le monde va*

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The author is Professor of History at the State University College at Buffalo.

[1]See my essay-review of Anthony Arblaster (Raico 1989, pp. 157–68).

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de lui-même ("the world goes by itself") encapsulated the liberal philosophy.[2]

Sometimes through revolution, more often through piecemeal reform, liberalism accomplished much of its program. Throughout the Western world a system developed based on free labor, clear individual property rights, and freedom of exchange. Nowhere—not even in England or America—was this system consistently realized in every aspect of economic life. Yet, as the great Austrian economist Ludwig von Mises (1927, p. 1) put it, it was enough to change the countenance of the world. For the first time, mankind was able to escape the Malthusian trap.[3] With the enormous increase in population came a steadily increasing per capita income. What this dry little fact meant in the lives of the many, many millions still awaits its poets and novelists. In reality, the only imaginative writer to have done justice to this great transformation was the novelist who was born in Leningrad, came to America, and wrote under the name of Ayn Rand.

But the bureaucratic-military state that had emerged in Europe in the early modern period, though excluded from some areas of social life, remained entrenched. Soon it began to expand again. By the early 19th century, independent thinkers all across the political spectrum, from conservatives to anarchists, were alarmed at the growth of the parasitic state.[4] Even in England—in 1830—the liberal historian Thomas Babington Macaulay (1907, p. 221) could conjure up the specter of "the all-devouring State." This was a problem that also concerned Karl Marx and Friedrich Engels.

[2]It is true that sometimes liberals in the earlier period sought to use the State to thwart the will to domination of the lesser powers—church, feudal estates, artisans' guilds, and so on. But after the French Revolution and Napoleon, it grew increasingly clear where the threat to liberty lay.

[3]There is a large and growing literature on this subject. Basic introductions to this topic are Jones (1987) and Rosenberg and Birdzell (1986).

[4]In his own day, Bakunin (1972, pp. 343–44) provided an interesting insight into the creation of a parasitic state *ab ovo:*

> There are no nobles, no big landowners, no industrialists, and no very wealthy merchants in Turkish Serbia. Yet in spite of this there emerged a new bureaucratic aristocracy composed of young men educated, partly at state expense, in Odessa, Moscow [and elsewhere] . . . these young men [had] distinguished themselves by their love for their people, their liberalism, and lately by their democratic and socialistic inclinations. But no sooner did they enter the state's service than the iron logic of their situation . . . took its toll. . . . Since there is no other employment for educated young men, they become state functionaries, and become members of the only aristocracy in the country, the bureaucratic class.

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Marxism and the Parasitic State

As has been sometimes noted (Hunt 1974, pp. 124–31; Conway 1987, pp. 162–64; Raico 1977, pp. 179–83), Marxism contains two rather different views of the state. Most conspicuously, it views the state as the instrument of domination by exploiting classes that are defined by their position within the process of social production, for example, the capitalists. The state is simply "the executive committee of the ruling class." Sometimes, however, Marx characterized the state itself as the independently exploiting agent. In *The Eighteenth Brumaire of Louis Bonaparte*, Marx considered the state as it developed in France. In a brilliant passage, (which Bertrand de Jouvenel [1949, p. 9] quoted in his classic, *On Power*, as an example of "The Minotaur Presented"), Marx declared:

> This executive power, with its enormous bureaucracy and military organization, with its ingenious state machinery, embracing wide strata, with a host of officials numbering half a million, besides an army of another half million, this appalling parasitic body, which enmeshes the body of French society like a net and chokes all its pores, sprang up in the days of the absolute monarchy.

All regimes assisted in the growth of this state parasite, according to Marx (Marx and Engels 1983, vol. 1, p. 477):

> Every *common* interest was straightway severed from society . . . snatched from the activity of society's members themselves, and made an object of government activity. . . . All revolutions perfected this machine instead of smashing it. The parties that contended for domination regarded the possession of this huge state edifice as the principal spoils of the victor.

Some 20 years later, Marx (Marx and Engels 1983, vol. 2, p. 222) spoke of the Paris Commune aiming at restoring "to the social body all the forces hitherto absorbed by the state parasite feeding upon and clogging the free movement of society." In 1891, in his preface to Marx's *Civil War in France*, Engels (Marx and Engels 1983, vol. 2, p. 188) referred to the United States:

> [There] we find two great gangs of political speculators, who alternately take possession of the state power and exploit it by the most corrupt means for the most corrupt ends—the nation is powerless against these two great cartels of politicians who are ostensibly its servants, but in reality dominate and plunder it.

Thus, the conception of the parasite state is clearly enunciated by the founders of Marxism. Several decades before they wrote, however, an influential group of French liberals had already singled out the parasitic state as the major example in modern society of the

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plundering and devouring spirit. This school of liberalism elaborated a doctrine of the conflict of classes and, in this respect, had not only a logical, but also a historical, connection with Marxism. Moreover, it can be taken as virtually the ideal type of authentic, radical liberalism and, in that respect, has relevance to the present day. Indeed, scholars are beginning to identify writers associated with this school as pioneers in the theory of rent seeking.[5] For these reasons, I think it is worthwhile briefly to sketch the views of these liberals.

Class Conflict Theory and the French "Industrialist" Liberals

In a well-known letter written in 1852 to his follower, Joseph Weydemeyer, the first exponent of Marxism in the United States,[6] Marx asserted:

> No credit is due to me for discovering the existence of classes in modern society or the struggle between them. Long before me, bourgeois historians had described the historical development of this class struggle and bourgeois economists, the economic anatomy of the classes.[7]

The two most prominent "bourgeois historians" whom he named were the Frenchmen, François Guizot and Augustin Thierry; two years later, Marx referred to Thierry as "the father of the 'class struggle' in French historiography."[8] This "bourgeois" lineage of the Marxist theory was freely conceded in later years by Engels and the Marxists of the Second International period, such as Plekhanov, Franz Mehring, and Lenin.[9]

Liberal class conflict theory emerged in a polished form in France during the Bourbon Restoration, following the final defeat and exile of Napoleon. From 1817 to 1819, two young liberal intellectuals, Charles Comte and Charles Dunoyer, edited the journal, *Le Censeur Européen*. Beginning with the second issue, Thierry collaborated closely with them. *Le Censeur Européen* developed and disseminated a radical version of liberalism, one that drew on a wide tradition

[5]Patricia J. Euzent and Thomas L. Martin (1984, pp. 255–62) have persuasively argued that Say was an important source for the modern theory of rent seeking. On Destutt de Tracy, see Dimand and West (1989, pp. 210–15).

[6]Marx to J. Weydemeyer on March 5, 1852 (Marx and Engels 1965, 67–70).

[7]Marx (Marx and Engels 1965, p. 69) stated that his own contributions were limited to having shown that classes are not a permanent feature of human society, and that the class struggle will lead to the dictatorship of the proletariat and thence to a classless society.

[8]Marx to Engels on July 27, 1854 (Marx and Engels 1965, p. 87).

[9]See, for instance, Lenin ([1917] 1943, p. 30).

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of French liberal thought that included Condorcet, Jean-Baptiste Say, Benjamin Constant, and the Idéologue school led by Destutt de Tracy. In turn, it continued to influence liberal thought up to the time of Herbert Spencer and beyond. Moreover, through Henri de Saint-Simon and his followers and through other channels, it had an impact on socialist thought as well. Comte and Dunoyer called their doctrine *Industrialisme*.[10]

The greatest influence on the Industrialists was Jean-Baptiste Say. Say (1815, p. 14) held that wealth is composed of what has value, and value is based on utility:

> [The different ways of producing] all consist in taking a product in one state and putting it into another in which it has more utility and value . . . in one way or another, from the moment that one creates or augments the utility of things, one augments their value, one is exercising an industry, one is producing wealth.

All those members of society who contribute to the creation of values are deemed productive, including not only workers, peasants, scientists, and artists who produce for the market, but also capitalists who advance funds for productive enterprise (but not rentiers off the government debt). Say awards pride of place, however, to the entrepreneur; Say was one of the first to realize the boundless possibilities of a free economy led by creative entrepreneurs (Allix 1910, p. 309).

But categories exist of persons who consume wealth rather than produce it. These unproductive classes include the army, the government, and the state-supported clergy—what could be called the reactionary classes, which are associated by and large with the Old Regime. Still, Say was quite aware that anti-productive and anti-social activity was also possible, indeed, altogether common, when otherwise productive elements used state power to capture privileges (Say [1880] 1964, pp. 146–47).[11]

The Class Conflict in History

Following Say, the Industrialist liberals posited that society's purpose is the creation of "utility" in the widest sense: the goods and services useful to individuals in the satisfaction of their needs and desires. In striving to meet their needs, individuals have two alternative means available: They may labor to produce wealth themselves,

[10]See Dunoyer (1880), Halévy ([1907] 1965), and, especially, Liggio (1977).

[11]As Euzent and Martin (1984) point out, Say was familiar with why "those engaged in any particular branch of trade are so anxious to have themselves made the subject of regulation." (Say [1880] 1964, pp. 176–77).

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or they may plunder the wealth that others have produced (Comte 1817a, pp. 1–2, 9).[12] To attempt to live without producing is to live "as savages." The producers are "the civilized men."

The Industrialist doctrine may be summarized in the statement that the history of all hitherto existing society is the history of struggles between the plundering and the producing classes. Feudalism, for instance, was essentially a system for the spoliation of domestic peasants by the warrior elite of "noblemen." With the rise of towns in the 11th century, one may even speak of two nations sharing the soil of France: the plundering feudal elite and the productive commoners of the towns.

The rapacious nobility was eventually succeeded by equally rapacious kings whose "thefts with violence, alterations of the coinage, bankruptcies, confiscations, hindrances to industry" are the common stuff of France's history (Comte 1817b, pp. 20–21). With the growth of wealth produced by the commoners, or Third Estate, additional riches became available for expropriation by the parasitic classes.

In modern times, the main types of idle classes have been professional soldiers, monks, nobles, bourgeois who were ennobled, and governments (Dunoyer 1817, pp. 119–26).

Peace and Freedom

A pro-peace position was central to the Industrialist's point of view: The motto on the title page of each issue of *Le Censeur Européen* was *paix et liberté* (peace and freedom).

The Industrialist attack on militarism and standing armies was savage and relentless. In a typical passage, Dunoyer (1817, p. 120) stated that the "production" of Europe's standing armies has consisted in "massacres, rapes, pillagings, conflagrations, vices and crimes, the depravation, ruin, and enslavement of the peoples; they have been the shame and scourge of civilization."

Particularly anathematized were wars engendered by mercantilism, or "the spirit of monopoly . . . the pretension of each to be industrious to the exclusion of all others, exclusively to provision the others with the products of its industry" (Dunoyer 1817, p. 131). In the course of a jeremiad against the imperialist foreign policy of the English, Dunoyer (1817, p. 132) stated, significantly: "The result of this pretension was that the spirit of industry became a principle more hostile, more of an enemy to civilization, than the spirit of rapine itself."

[12]The similarity to Franz Oppenheimer's analysis is obvious. See Oppenheimer (1975).

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In the modern period, the nobles, no longer able to live by directly robbing the industrious, began to fill government positions; they lived by a new form of tribute, "under the name of taxes" (Comte 1817b, p. 33). Members of the bourgeoisie who achieved noble status no longer tended to their own businesses and, in the end, had no means of subsistence but the public treasury. Finally, governments, while burdening the producers with taxes, "have very rarely furnished society with the equivalent of the values they received from it for governing" (Dunoyer 1817, p. 124).

The Industrialist writers looked forward to "the extinction of the idle and devouring class" and to the emergence of a social order in which "the fortune of each would be nearly in direct ratio to his merit, that is, to his utility, and almost without exception, none would be destitute except the vicious and useless" (Comte 1817a, pp. 88–89).

State Functionaries as Exploiters

Augustin Thierry (1818, pp. 228, 230) enunciated the Industrialist adherence to strict laissez faire in his review of Tracy's *Commentaire sur l'Esprit des Lois de Montesquieu:*

> Government should be good for the liberty of the governed, and that is when it governs to the least possible degree. It should be good for the wealth of the nation, and that is when it acts as little as possible upon the labor that produces it and when it consumes as little as possible. It should be good for the public security, and that is when it protects as much as possible, provided that the protection does not cost more than it brings in. . . . It is in losing their powers of action that governments improve. Each time that the governed gain space, there is progress.

Thierry (1818, pp. 205–6) seconds Destutt de Tracy: "Commerce consists in exchange; it is society itself," and "taxation is always an evil."

The function of government is to ensure security—"whether there is a danger from outside or whether the mad and the idle threaten to disturb the order and peace necessary for labor." In a simile freighted with meaning in the rhetoric of Industrialism, Thierry (1818, p. 244) asserted that any government that exceeds these limits ceases to be a government, properly speaking:

> Its action can be classed with the action exerted upon the inhabitants of a land when it is invaded by soldiers; it degenerates into domination, and that occurs regardless of the number of men involved, of the arrangement in which they order themselves, or what titles they take.

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In fact, the class of contemporary exploiters that the Industrialist writers investigated more than any other was the government bureaucrats. As Comte (1817b, pp. 29–30) put it:

> What must never be lost sight of is that a public functionary, in his capacity as functionary, produces absolutely nothing; that, on the contrary, he exists only on the products of the industrious class; and that he can consume nothing that has not been taken from the producers.

True to the Industrialist concentration on the "economic factor," Dunoyer (1819, pp. 75–118) surveyed "the influence exercised on the government by the salaries attached to the exercise of public functions." In the United States—always the model Industrialist country—official salaries, even for the president, are low. Typically, American officials receive an "indemnity" for their work, but nothing that could be called a "salary" (Dunoyer 1819, p. 77). In France, on the other hand, public opinion is shocked not by the exercise of power being made into "a lucrative profession," but by its being monopolized by a single social class (Dunoyer 1819, p. 78).

Public expenditures, however, bear almost an inverse relationship to the proper functioning of government: In the United States, for instance, where government costs some 40 million francs a year, property is more secure than in England, where it costs more than 3 billion (Dunoyer 1819, p. 80). The characteristics of public employment are the reverse of those in private business. For example,

> . . . ambition, so fertile in happy results in ordinary labor, is here a principle of ruin; and the more a public functionary wishes to progress in the profession he has taken up, the more he tends, as is natural, to raise and increase his profits, the more he becomes a burden to the society that pays him [Dunoyer 1819, pp. 81–82].

As increasing numbers of individuals aspire to government jobs, two tendencies emerge: Government power expands, and the burden of government expenditures and taxation grows. To satisfy the new hordes of office-seekers, the government extends its scope in all directions. It begins to concern itself with the people's education, health, intellectual life, and morals; sees to the adequacy of the food supply; and regulates industry until "soon there will be no means of escape from its action for any activity, any thought, any portion" of the people's existence (Dunoyer 1819, p. 86). Functionaries have become "a class that is the enemy of the well-being of all the others" (Dunoyer 1819, p. 88).

Since the enjoyment of government jobs has ceased to be the private preserve of the aristocracy, it has become the goal of everyone

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in society (Dunoyer 1819, p. 89). Indeed, one might say that the chief result of the French Revolution was that members of the bourgeoisie were able to gain government jobs. In France there are perhaps "ten times as many aspirants to power than the most gigantic administration could possibly accommodate. . . . Here one would easily find the personnel to govern twenty kingdoms" (Dunoyer 1819, p. 103).

The State and Class Conflict in Liberal Theory

The concept of class conflict linked to the state is one that permeates the history of liberalism from beginning to end. It was especially conspicuous during the struggle against the old "feudal powers," but it is by no means limited to that period. The most radical and authentic liberals perceived the continuing existence of class exploitation by the state in the later 19th, and in the 20th, century.

As time went on, one area of state exploitation captured liberals' attention more than any other: militarism and imperialism. A very long list of examples could be given. In England, for instance, the quintessential liberal, John Bright, opposed the British occupation of Egypt in the 1880s because it was simply a "stock-jobbers' war" (Trevelyan 1913, p. 141). Jeremy Bentham, Richard Cobden, Herbert Spencer, and William Graham Sumner are a few of the liberals who opposed their governments' overseas wars. For generations, the theme of the most "doctrinaire" and consistent liberals was the appropriation by the state's military bureaucracy and its capitalist suppliers of wealth created by the producing classes. In the same spirit, an American writer (Fitzgerald 1972, p. xii) has identified the masses exploited by the military branch of the American state:

> It is undoubtedly true that subject population exploitation is a major objective of the military spending coalition. The people marked for exploitation, though, are not the masses of . . . peasants in underdeveloped countries. . . . The exploited masses are United States taxpayers, the most productive and easily managed subject population in the history of the world.

Contemporary Issues

As the French liberals knew, the expansion of government activity keeps pace with the increase in the number of state functionaries, who must somehow justify their incomes and jobs. And today, in every regime throughout the world, the number of state functionaries continues to grow. According to reports in the West, most of the relatively few Soviet bureaucrats who were dismissed under perestroika have been rehired by new intermediate agencies, production

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or research associations, or similar groups that are sometimes headed by the former minister himself. It is estimated that the number of Soviet bureaucrats has actually increased by 122,000, bringing the total to about 18 million.[13]

But the experience of hydra-headed bureaucracy is by no means limited to the Soviet Union. Administrations elected on platforms demanding a reduction of the legions of functionaries—whether in Brazil or the United States—seem somehow never to be able to realize their original intentions. It was good of Deputy Prime Minister Leonid I. Abalkin to point out that the U.S. Department of Agriculture has more employees than the Soviet State Commission on Procurement and Food.[14] The conclusion, however, is hardly the one Abalkin seems to favor—that "even" a market economy requires great armies of bureaucrats.

With the emergence of the welfare state, the opportunities for the state "enmeshing society in a net and choking all its pores" become literally endless. In every advanced country, a class now flourishes of state-funded social scientists whose profession consists in discovering and defining—out of the infinite mass of human misery—particular "social problems" that will become the material for further state activity (Gouldner 1970, pp. 344–51).

The monstrous growth of the state apparatus will not be stopped by those who, ignorant of economics and given to literary-moralistic musings, equate a private property market economy with totalitarianism. President Vaclav Havel of Czechoslovakia is, as Steve Pejovich (1991) has written, a "social-democrat," who continues to harbor a strong bias against capitalism and even against private property.[15] He recently warned against "the stupefying *dictatorship* of consumerism and of pervasive commercialism."[16] This "dictatorship," Havel feels, will tend to produce alienation. In the speech in which he discussed this problem, he appealed to German philosophers to help prevent this plunge into alienation by turning to "the service

[13]*Le Figaro*, 4 March 1990.

[14]*New York Times*, 15 April 1990.

[15]In the summer of 1990, Havel told the editor of *The Spectator:* "I have never said that we should build capitalism in our country. We want to build a functioning economic system, on which prospering economies and trade have been based for millennia, that is, long before capitalism arrived on the scene." Havel described himself as "a friend of various co-operative, collective forms of ownership, but at the same time I can see that purely private ownership has a legitimate right to exist parallel to them" (Lawson 1990, p. 10).

[16]*New York Review of Books*, 26 April 1990, p. 57; emphasis added.

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of renewing global human responsibility, the only possible salvation for the contemporary world."

I doubt that we require the help of German philosophers to remedy the ills caused by an over-emphasis on individualism and private rights. In any case, what is this "dictatorship" of consumerism, this "mindless materialism," of which Havel—and many other literary intellectuals from east-central Europe—speak? Is it the provision of compact-disc electronic systems to tens and soon hundreds of millions, enabling them to listen to nearly concert hall perfect versions of the music of Tchaikovsky, Shostakovich, and Rachmaninov? Does it consist in making available, in every Western country, well-produced paperback editions of all the great works of literature and philosophy, and of all the modern works as well—especially those that attack the "materialism" of the capitalist system? In America and other Western countries, millions of people have attained the degree of affluence that permits them to interest themselves, in an amateurish way, in original works of art—drawings, paintings, sculptures, and photographs. Their homes are filled with such works, mainly by local artists. Is the affluence that permits this middle-class amateurism another example of "materialism?"

I think a touch of the old Marxist skepticism is in order. For whom does President Havel speak when he derides "consumerism" and "commercialism"? Whose interests are served by eclipsing the market economy and the voluntary choices of consumers?

In the former socialist countries of east-central Europe, as elsewhere, there is in place a stratum of state-subsidized intellectuals in the media, the arts, the press, and education. Writers' Unions and their counterparts in other fields are everywhere. There is, moreover, a continuing process of the reproduction of this class. I suggest that their social position requires an ideology to justify the continuance of state funds. Perhaps the task of "renewing human global responsibility"—whatever that may be—will be at the center of it.

Conclusion

The "vulgar Marxism," which in the past dismissed liberal ideology as "nothing but" the rationalization of the bourgeoisie's interests cannot stand the test of critical examination. I have stressed a dimension of liberal ideology that clearly has great relevance for every nation.

A New Zealand scholar, J. C. Davis (1981, pp. 8–9), reflected on the rise of the Leviathan state during the past 400 years, a process spanning the globe:

> The comprehensive, collective state with its assumption of obligations in every aspect of human life, from health and employment,

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> education to transport, defense to entertainment and leisure, is a feature of every advanced state, whether of the East or the West, and of the aspirations of most Third World governments. Curiously, both revolutionaries and reactionaries, by their demands that the state more closely control social processes, have furthered the growth of Leviathan.

This description is one with which both the great French liberals, whom I have discussed, and Karl Marx could have agreed. The question remains: What realistic alternative exists to state-parasitism? The answer provided by a contemporary French scholar, Raymond Ruyer (1969, pp. 266–67), represents my own point of view and, I think, that of authentic liberalism:

> [One must] fully recognize a great truth, which rings as a scandalous paradox and a challenge to the beliefs and quasi-religious faith of the intelligentsia, both in the West and the East, namely, that the only choice is between a bureaucratized political State, seeking power and glory in every domain, including those of art and science; and an "anarchical" regime of self-direction in every economic domain first of all, but also in culture. But the heart of the paradox is . . . that it is only the liberal economic order that can promote "the withering away of the State" and of politics—or at least their limitation—it is not centralizing socialism.

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Privatization Solves All

Paul Craig Roberts

Both proponents and opponents of privatization emphasize its difficulties. This emphasis is wrong. It is far easier to give people property than to take it away from them. The Bolsheviks seized property all at once. They did not debate endlessly or demoralize themselves by emphasizing the difficulties. No one said, "Oh, the Soviet people, they have no experience with communism." If the Soviet people can endure 70 years of communism, they can certainly endure privatization and the end of bread lines.

The Communist party of the Soviet Union wasted the 20th century trying to do the impossible: to organize production without markets and private property. This ideological effort has failed at great cost, and now pragmatic leaders are attempting to create the conditions for economic success. They have put forward the Shatalin 500-Day Plan.

The Shatalin Plan calls for privatization and market prices; it even sets timetables. But this remarkable document suffers in two ways. It does not say how to achieve privatization, and it is unclear which comes first, privatization or market pricing.

Private Property and Price Liberalization

Reformers are bewildered about how to proceed. They realize that without market prices and capital markets there is no basis for valuation. At what prices, then, are assets to be sold? This problem leads many people to conclude that prices must first be freed to find out what things are worth, but without private property you cannot know.

When prices are freed, some will go up and others will go down. Falling prices will cause unemployment or large deficits, and higher

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The author holds the William E. Simon Chair in Political Economy at the Center for Strategic and International Studies.

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prices will produce complaints of profiteering and inflation. Both conditions will demand remedies and deflect the program from privatization. Moreover, these prices will not be accurate indications of asset values; without private property, resources are not free to be reorganized and moved from uses with low values to uses with high values. The result may be to undervalue resources that are locked into low value uses and to overvalue resources where prices are high.

I conclude that property rights will have to be given to the people before those rights can be sold and capital markets established.

Assigning Property Rights

Before property rights can be given to the people, a political decision must be made as to where the rights now reside. Mayor Anatoly Sobchak of Leningrad has asserted the city council's rights over state property in Leningrad, and Mayor Gavriil Popov has taken a similar position in Moscow. Conversely, Russia's President Boris Yeltsin has asserted the republic government's power over state property in its territory, which includes both cities. Meanwhile, the Soviet government has not formally relinquished its own claims.

For the government to have clear authority to convey clear titles, de jure privatization, in contrast to the de facto privatization under way, will have to begin with an act of nationalization at either the all-union or the republic level. If Gorbachev had moved quickly, he could have privatized on an all-union basis and strengthened the Soviet Union against the political disintegration that is now taking place.

After establishing a legal basis for conveying titles, the government should transform Soviet firms into stock companies and issue shares. Next, it should assign less than a controlling interest of the shares individually to managers and workers to avoid the problems of workers' control and the tendency to disinvest by paying out profits and depreciation in current wages. Then it should assign a percentage of the shares to a mutual or social fund that, in turn, issues shares assigned individually and equally to the population. Finally, it should reserve a percentage of shares for sale to Soviet and foreign investors, and assign a percentage of shares (less than a controlling interest and, of course, nonvoting shares or bond equivalents) to various levels of government.

Land must be assigned to individual peasants and agricultural workers (who would receive a correspondingly smaller share in the social fund), and apartments must be assigned to individual tenants.

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This distribution would accomplish many goals, and the precise percentages would reflect decisions about individual and government responsibility. For example, a relatively large percentage could be assigned to the social fund and a portion of that could be made a mandatory holding so that each person would have his or her own social insurance, safety net, and retirement system. The percentages assigned to government would provide income, in lieu of taxes, to finance services provided by government.

Sales to foreigners attract talent and foreign exchange. Sales to citizens accommodate people who have accumulated wealth and financial balances from de facto property rights.

Once property rights are assigned, prices can be freed and markets will establish values for the shares that have been assigned, thus creating a priced market for sale of remaining shares. Changes in the level and relation of prices will be reflected in share values and earnings, and the social fund will provide a cushion to protect the population from inflation and unemployment. Losses and gains will be widely distributed and equally shared through the social fund.

Privatizations based on the assignment of rights are much more politically effective and rapid than sales based on complicated valuations that tend to be insider deals. Privatizations in which everyone is given a fair stake result in a convergence of interests rather than in social division.

Privatization and Ruble Convertibility

Privatization is the first step of reform, not the last. The ruble cannot be a convertible currency until it can purchase capital. If the ruble cannot purchase the real resources of land, labor, plant, and machinery, it has no basis for conversion into other currencies. Linking the ruble to a commodity, such as gold, before privatization would result in a flight from the ruble to gold. It is the capability of a currency to purchase productive assets that makes it convertible.

No Markets without Property

There cannot be markets without property, and prices cannot be free before resources are free to follow the prices. Investments must move in the direction of profits and away from losses. This movement cannot happen unless property rights are assigned. Economists and bureaucrats cannot perform the functions of owners. Once rights are assigned, attitudes and activities will be completely reoriented. People will scramble to ensure that their property has value, and the result of their efforts and incentives will be a successful economy.

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Spontaneous Privatization

In the West, private property rights did not result from a political program or from the application of an ideology to society. They evolved over time. De facto rights became de jure rights, and use rights became exchange rights. Historically, people who controlled resources became the owners of resources. This process is already under way in the Soviet Union. The distribution system has largely been privatized, and there is a system of de facto private property rights exercised by black marketeers, gangsters, and people in positions to divert state resources to private uses. The Communist party is now supposedly privatizing buildings and means of production by declaring itself or collections of its members as the owners. These rights are not sanctioned by law and are resisted by the new politicians whose power rests on their responsiveness to the people. This ongoing process of spontaneous or de facto privatization has made reformers and democratic forces suspicious of Gorbachev's indecision. He fiddles while the old order steals the property.

At the heart of many conflicts in the Soviet Union is the conflict over property. It remains to be seen whether democratically elected politicians can prevent powerful interests from plundering the country and whether private property will emerge from a process similar to the enclosures or from a plan based in law.

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Property, Markets, and Money

Peter Bernholz

Ends to Be Reached

For a country to move from a centrally planned economy that lacks innovative capabilities to a market economy, most rights to make decisions must be transferred to individuals, firms, households, and voluntary associations. Markets must be deregulated, and prices must be free to be agreed on or set by these decentralized agents. No central planning authority and no industry ministries now coordinate the activities of firms and households by enforcing central plans. Thus, markets and prices must coordinate independent decisions of agents. For efficiency, prices have to be formed in competitive markets to express the scarcity of goods. Only then can prices adequately (1) aggregate information about the present and expected scarcity of goods and services, (2) inform everybody about rational use or saving of resources and about unused opportunities, and (3) guide the search for new, valuable information (Hayek 1945). But as Meckling and Jensen (1984) have stressed, it is not just the existence of a price system but, above all, a system of strong private property rights that will secure the full informational advantages of markets. Such property rights allow individuals or groups not only to destroy and use goods in production and consumption (to let, to buy, to sell, and to transfer them to others), but also to capture the full value of the goods when alienating these rights.

The possibility of alienating (selling, bequeathing, transferring) property rights and enjoying the full market value of sold goods has an important bearing on the problem of information. More often than not, knowledge that could be applied, together with a certain

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The author is Professor of Economics at the University of Basel and a member of the Council of Advisors to the German Minister of Economics.

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combination of resources to produce new goods or to offer new combinations of goods and services that could be sold at a profit, is not available to owners of the respective resources. Whenever this happens, there are two possible ways to bring knowledge and resources together: either transfer the knowledge to the people who own the rights to use the resources, or vice versa. Obviously, in centrally planned economies, the first possibility is used: a tendency reinforced by the legal nature of publicly owned property. A private property system with markets, on the contrary, has both alternatives available, because the means of production, which can be used together with the respective knowledge, are alienable. That is, resources can be bought by the holders of information. Moreover, holders are able to compensate resource owners, since the holders' knowledge ensures that they can make a more profitable use of the resources than the present owners.

There is no doubt that knowledge is also transferred to owners of resources. But such transfers are sometimes very costly (they may also reveal all or part of the information to outsiders and thereby decrease its value), difficult, or even impossible. Hayek mentions the knowledge of particular circumstances (of time and place). Moreover, particular skills acquired by individuals often cannot easily be transferred (taught) to others. Finally, one would expect that new inventions are generally very difficult to transmit, because new concepts and descriptions must be used and because only a few people (for example, specialized engineers or scientists) may be able to understand the new messages. Another difficulty is a general mistrust of unknown new developments. In all these cases in which it is either impossible or too costly to transfer knowledge, it may well be possible to acquire the rights to the complementary resources at low transfer costs. This fact thus constitutes an obvious informational advantage of a market system with strong property rights.

At the same time, this system implies a rather efficient control of the use made of property rights and of information. Since property owners get the full value of their goods in the market (a value that reflects the discounted expected stream of values stemming from possible future uses), they receive the profits or losses caused, at least partly, by the good or bad use of their resources and of the knowledge they can apply. This system of rewards and punishments is, moreover, strongly information saving and selective according to actual performance.

Thus, the introduction of competitively formed market prices and of strong private property rights is an important ingredient for reforming formerly planned economies. Another condition for well-func-

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tioning markets is a sound money and credit system. The monetary regime has to be organized in a way that economic agents can expect money to preserve its value until it is spent on purchasing goods and services. Otherwise, people will restrict their use of money and of assets denominated in money—a behavior that would lead to a shrinking of capital and credit markets, especially for long-term credit instruments—to a fall of investment and to a misallocation of resources hindering economic growth.

In a decentralized economy, credit and capital markets—as well as financial institutions such as banks, investment funds, insurance firms, and stock exchanges—must play an important role in coordinating intertemporal consumption and investment decisions of households, firms, and government agencies. They also provide for pooling of risks and diversification of assets. Stock markets not only play a role in having a multitude of shareholders finance big firms, but also in controlling bad management through the threat of takeovers if bad policies lead to a fall of share prices.

Households as a group are savers; they forgo consumption and directly or indirectly grant credits to firms and governments. Since the latter agents spend the proceeds of these credits on buying investment goods and on extending and renewing their capacities, resources are redirected to produce investments instead of consumers' goods, a fact that allows innovation and higher economic growth. Thus, it is only with the help of financial markets and financial institutions that the problems of the intertemporal allocation of resources can be solved. But since credits are denominated in money, a stable money is a precondition for a well-functioning financial system.

The importance of a well-developed and stable monetary regime for the working of a decentralized market economy was clearly recognized by German neoliberals (Bernholz 1989). For example, Walter Eucken (1952, p. 205) stated: "All efforts to realize a competitive order are in vain as long as a certain stability of money has not been reached." In *Die Grundlagen der Nationalökonomie*, Eucken (1939) had emphasized that the function and importance of money decrease more and more if economies move from a pure market system toward a planned economy (and vice versa). On the other hand, this means that stable money without free prices would be of little help. In a memorandum written for the Office of the Military Government of the United States in postwar Germany (April 1946), more than two years before the West German currency reform, Eucken pointed out the necessity of a currency reform. But in his opinion, such a reform would be useless without the restoration of a free-market economy,

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since "in the economy even the existing opportunities to produce and to reconstruct are not used, stocks of goods in industry and in the wholesale and retail trades are withheld, market efficiency in agriculture continues to decrease and finally many people do not even wish to work" (Eucken [1946] 1961, p. 205).

It is important to recall that such ideas, which were developed by German neoliberals from the beginning of the 1930s, proved to be decisive for the reform of the West German economic system in 1948 and afterward, a reform that laid the basis for rapid reconstruction and a marvelous growth performance of the economy during the following one and a half decades.

Financial and Monetary Conditions in Planned Economies before Reforms

In a planned economy steered mainly by prescribing targets for physical production and by centrally allocating inputs for this purpose, prices, money, and financing play only a subordinated role. The targets have to be realized, and it is unimportant whether this realization leads to losses in terms of a monetary calculation (and to financial deficits) or not. This conclusion is true not only for productive plants, but also for government agencies from communities up to the central government. Losses or deficits are more or less automatically compensated through financial allocations. Otherwise, production plans might not be fulfilled. Economic agents thus perform in a world of "soft budget constraints" (Kornai 1971, 1986). Besides fulfilling the task of providing the required finances, the banking system is used only for monitoring economic agents. Other financial institutes and financial markets are virtually absent.

Many prices, especially for essential goods, are set below market-clearing prices. The resulting excess demand is met either by rationing or by queuing. Three reasons probably cause such price policies. First, for consumer goods there is scarcely ever a lack of demand, a fact that seems to demonstrate that planning has been correct in targeting production of the respective goods. Second, in a communist society, ideology requires an allocation of daily necessities, like food and housing, according to need and not depending on income. Perhaps most important is the third reason: Scarcity of goods caused by below-market equilibrium prices bestows power on functionaries and managers to distribute goods at their discretion, to ask for political and other favors, or to ask for other goods in exchange.

Soft budget restraints and below-equilibrium prices often lead, however, to a need for financial support for firms and government

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agencies to cover resulting losses, investment programs that were too ambitious, or subsidies caused by supporting low prices. On the other hand, many households and profitable firms are willing to acquire more goods but are unable to find them. These households and firms, therefore, are forced to accumulate savings and surpluses. The surpluses are used for short-term or saving deposits at the state bank as far as they are not used by government as revenue. For firms these deposits "belong" to their investment, social, and wage funds. Savings deposits in the Soviet Union amounted to 220.8 billion rubles in 1985 and 297.5 billion rubles in 1988; deposits of firms reached 250 billion rubles in 1988 (Vanous 1989).

Thus there may be, on one side, a creation of money to cover losses, excess investments, price subsidies, and budget deficits that are not financed by government revenue or by credits extended by state banks out of deposits. On the other side, short-term financial assets are accumulated by households and firms for which no corresponding value of goods exists.

Another weakness of the financial system consists in the underdeveloped tax system (McKinnon 1989). Since firms are state owned, the government can directly appropriate their profits for its own expenditures. Those profits have to be deposited at the state bank if they are not earmarked for the firms' special funds. Moreover, the government can fix prices in a way that firms' revenues are, on the average, sufficiently above expenditures for wages and other inputs. As a consequence, a developed tax system is not needed. In the Soviet Union, for example, only some turnover taxes have to be paid by firms when goods are moving to the retail business. The nature of those taxes is thus not much different from a direct appropriation of profits, and they cover only a small part of government expenditures. In China before reforms began in 1979, direct profit remittances made up a substantial part of total revenues (Blejer and Szapary 1989, p. 9). In the German Democratic Republic (GDR), too, receipts from state-owned Kombinats and firms amounted to 76.34 percent of total government revenues in 1988 (Institut der Deutschen Wirtschaft 1990, p. 5).

It follows from the above analysis that centrally planned economies, which are trying to move toward a decentralized market system, face important problems in the monetary, credit, and financial spheres. Budget deficits, financing of losses, over-ambitious investment projects, subsidies, and excessive money creation have to be ended. The monetary overhang has to be removed. Given this situation, we must ask how these problems can be solved with least resistance, that is, without endangering the reform process. To be

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better able to do so, however, we should discuss some political economic problems that typically arise from mistaken, inadequate, or wrongly coordinated reform measures.

Monetary and Budget Problems that May Arise during the Reform Process

The above analysis has shown that reform measures freeing prices and markets; transferring rights to make decisions to households, firms, and communities; and establishing extended and strong private property rights must be coordinated with the development of sound government finances, credit markets, financial institutions, and, above all, a stable monetary system.

Several political-economic obstacles make it difficult to introduce a system of stable money and sound fiscal policies in a formerly centrally planned economy. Reformers are often afraid to remove price regulations at one stroke. They prefer to keep prices of some essential goods fixed at a low level so as not to dissatisfy the population. They also do not want to strengthen the hand of politicians opposed to the reforms. Thus, it is not surprising that (for example, in China) price subsidies still amounted to 20 percent of total expenditures of the central government in 1983, four years after the beginning of reforms (Feltenstein and Farhadian 1987, pp. 142–43). Also, because politicians are afraid of the possible consequences of unemployment, they shy away from stopping the extension of new credits or subsidies to loss-making firms and from allowing them either to reorganize or to go bankrupt, even if bankruptcy laws have been formally reintroduced.

One also has to keep in mind that low prices, still fixed by the government, may be the reason for losses if input prices are left to the free market. In this case, firms are not responsible for losses and should not go bankrupt. Fixing too-low prices and subsidizing losses, however, lead to massive borrowing requirements.

Another frequent characteristic of reform processes is a decentralization of economic decisionmaking to firms, communities, and provinces that is not accompanied by widespread privatization. Often reformers are not prepared to privatize more than a limited part of the economy. This happens because of ideological reasons; because of resistance from planning bureaucracies afraid of losing their influence; and because of functionaries, managers, and workers of firms believing that their jobs are threatened (Bernholz 1975, chap. 7.4). The reluctance to privatize is enhanced by difficulties in selling

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loss-making firms and by an unwillingness "to give them away for nothing."

It follows that inadequate measures are often taken to decentralize. For example, local and provincial authorities are made rather independent and are turned into proprietors of middle-sized and large firms, but the largest firms remain the central government's property. Only for small and/or newly founded firms is private property allowed. Independent farmers can only lease land and must rent equipment from envious farm cooperatives. Or some degree of independence is given to labor-managed firms while other plants are turned over to cooperatives. A corresponding policy could be observed during recent years in the Soviet Union, Hungary, and China.

Such decentralization connected with weak property rights implies, however, a substantial weakening of the motivation to work, to invest efficiently, and to innovate. Moreover, politicians and bureaucrats of local and provincial governments look at "their" firms mainly with an aim to protect employment and to extract profits for their own expenditures, if firms are profitable. It follows that these politicians are interested in preventing loss-making firms from going bankrupt, and they support the extensive investment programs demanded by others. To get the needed financial assistance to cover losses and credit demands, communities and provincial authorities thus tend to support the credit demands of firms and to exert pressure on the banking system to grant these demands. They are not prepared to cover these financial needs out of their own budgets since the reduction of other expenditures would be politically disadvantageous. Moreover, as will be seen below, the underdeveloped tax system leads inevitably to budgetary problems during the reform process.

Similar behavior patterns have to be expected for politicians, bureaucrats, and functionaries of the central government. They must look for finances to cover losses and large investment demands of government-owned firms and must pay for the price subsidies extended. As long as no sanctions threaten for losses and deficits, little fiscal responsibility can be expected.

Decentralization, together with an underdeveloped tax system, also tends to worsen the budget situation, at least during the earlier stages of the reform process (McKinnon 1989). When firms are decentralized, turned into labor-managed firms or cooperatives, or transferred into the ownership of communities or provinces, their profits can no longer be automatically appropriated as revenue by the central state. Moreover, high taxes on profits, even if they could be

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introduced immediately, would prevent the increased motivation to work more efficiently and to innovate, which are the very aims of decentralization. Thus profits can be only partly taken away by the state, even if the state still owns the firms.

If new taxes are only gradually introduced because of technical difficulties and, more importantly, because of political reasons, then the budget deficit rises during the reform process. Among the technical difficulties for new taxes are the necessary development of bookkeeping; of tax bureaus and controllers; and of reasonable definitions of income, profits, and value added. Some taxes that could probably be introduced more easily than income, wage, or profit taxes are turnover, sales, or value-added taxes. The latter provide high revenue, their base can be easily defined, they are easier to calculate, and they can be applied to all firms independent of the kind of ownership relations. Also, political resistance to them will probably be smaller, since they are not felt by the population as strongly as income tax.

The above considerations concerning the development of government revenue and of a budget deficit during the reform are supported by the experience of China and the Soviet Union. Revenues have fallen in China since 1979 and in the Soviet Union since 1985. Moreover, in the Soviet case, expenditures rose at the same time revenues declined, which caused the deficit to increase rapidly since 1986.

Our analysis has shown that there are several reasons to expect losses of firms; excessive credit demands for investments; and budget deficits of communities, provinces, and the central government during and as a consequence of the reform process. Thus, a strong pressure on the banking system develops to grant credits not covered by savings. But even if such credits were partially or totally financed by savings, their use to cover losses or budget deficits would not lead to a corresponding increase of production. Therefore, the overhang of monetary assets, which existed before the reform, would be further increased.

If savings are not sufficient to finance credits that are granted for investment or to cover losses and deficits, the pressures on banks will spread to the central bank through the banks' need to refinance themselves. If the central bank submits to these demands, the monetary base increases and inflationary tendencies are strengthened.

It is probable that banks will not resist the pressure stemming from influential local and provincial politicians, bureaucrats, and mangers, who can argue that at stake are employment, the survival of firms, and the functioning of communities and provincial govern-

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ments. Moreover, the banks' power to resist pressures is weakened by the fact that members of local and provincial governments, as well as of important firms, are sitting on their boards. Empirical evidence supports our hypothesis (for China, see Bernholz 1990b). Note also that resistance is diminished if banks are not forced by the threat of bankruptcy, because they can always hope to be refinanced by the central bank.

The central bank finds itself in a similar situation. How can it resist the demands of banks to be refinanced if bankruptcy is threatening those banks? How can it deny fulfilling the credit demands of the central government, which is represented along with major banks on its board—especially when the central government has the power to remove the bank's directors if the budget deficit is not covered? Obviously, the central bank will not resist such demands if it is not independent from the government and if no sanctions threaten its directors when it surpasses certain monetary targets tied to real growth of GDP.

In summary, before reforms, a budget deficit usually exists and a substantial monetary overhang, that is, repressed inflation has accumulated. The reforms do not remove, but rather increase, the budget deficit and money creation. This increase is caused by decentralization without adequate privatization, by an underdeveloped tax system, by maintenance of loss-making firms and below-equilibrium prices for essential goods, and by financing investment projects that are too ambitious.

Because many prices have been freed by now, open inflation begins. It amounted to about 8 percent in the Soviet Union in 1989 and reached about 20 percent in Hungary and China. The overhang of short-term financial assets in the Soviet Union is estimated to have reached 250 billion rubles for firms and 339.5 billion rubles for households in 1988 and 1989, respectively. The budget deficit amounted to 13.1 percent of GNP in 1989, and it is estimated that 3.5 percent of the deficit was financed by money creation in 1988.

The population understandably attributes open inflation to reforms, especially because inflation follows the freeing of prices. Opponents of reform can use this reaction to ask for a postponement of further reforms or even for a return to the old system. As a consequence, the independence of firms, communities, and provinces may be curtailed again, and prices may be fixed once more. It seems possible that the political unrest and the demand for democratic reforms in China's major cities in 1989 were caused by inflation, which especially reduced the real incomes of city intellectuals.

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The factors responsible for open inflation during the reform process may, however, lead to a quite different political reaction. Politicians, who have observed events in other countries that are trying to reform, may be so afraid of political consequences from a possible reform that they will not risk freeing prices, will prefer a very slow pace, or will try to adapt relative prices to more adequate levels by bureaucratically administered price changes. Such policies obviously endanger the reform process.

Our analysis shows that political-economic relationships connected to monetary and fiscal problems do not allow an optimistic prognosis for reforms in formerly centrally planned economies. Even in such a situation, a new government may, if driven by an acute crisis, decide to take drastic reforms. This seems to have happened in Poland, where the Council of Ministers of the new government, dominated by Solidarnocz, decided in October 1989 to eliminate the budget deficit, free prices and exchange rates, abolish subsidies, stabilize the money supply, and privatize industry. These decisions, part of which have already been enacted, were taken in the face of a desperate economic situation and a monthly inflation of 40 percent in August 1989.

Even such radical reforms may, however, lead to severe problems. First, with rising inflationary expectations, the velocity of money may be multiplied up to a factor of 20 (Bernholz 1990a), which implies a vast inflation potential even at a constant money supply. Second, it is well known that the budget deficit grows with high rates of inflation because of the so-called Tanzi effect (see Bruno et al. 1988 and Bernholz 1988). But this effect may lead again to strong pressures to finance the deficit by money creation. It is not known whether the Polish government has taken these dangers into account.

Measures to Ease the Transition from Plan to Market

The analysis in the previous section suggests how the dangers of the reform process may be overcome or limited by adequate measures correctly timed. To prevent unfavorable economic developments following an uncoordinated stepwise approach and to minimize political resistance, all reform measures must be introduced in a consistent time sequence. Also, as many measures as possible should be taken at one stroke. Above all, the deregulation of prices and of monetary and fiscal reforms should be taken together. The West German reforms of June 1948, leading to the "economic miracle" (Möller 1976, Pfleiderer 1979, Sauermann 1979, Domes and

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Wolfsohn 1979), are an example of an impressive success story. The currency reform of June 20 reduced all financial assets and debts dominated in Reichmarks (RM) by a factor of 20:1 into Deutschemarks (DM) assets and debts. Another 5 percent were blocked, but only 1.5 percent of them were freed later on. Moreover, on Sunday, June 20, 40 DM in banknotes per capita were issued everywhere. On Monday, June 21, all public offices that had to make payments (including the military government, the railway system, and the post offices) and all other firms received a "first installment" in the form of checking deposits at their bank. These installments were prescribed by law in an amount that could be simply calculated. Thus, firms received 60 DM per employee. Moreover, the law determined that all recurrent obligations in RM, such as wages, rents, and payments for leases, had now to be paid in DM (the conversion factor was 1:1). The changes implied for banks and banking deposits were somewhat more complicated and need not be described here.

More important most prices were freed and price regulations removed at one stroke together with the currency reform. Ludwig Erhard, then Director of the Economic Administration, took those courageous steps against strong political opposition, especially in the Social Democratic Party and against the warning voices of many "experts." A corresponding decision had been recommended by the historic *First Report of the Advisory Board at the Economic Administration of the United Economic Area of April 18, 1948* (translated in Richter 1979, pp. 449–53; for the participation of German neoliberals in shaping this report, see Bernholz 1989, p. 193).

It has to be mentioned, on the other hand, that the prices of some basic foods and of most raw materials remained controlled and that rationing remained in force for a limited time. For some textiles and shoes, price controls but not rationing were abolished for several months. As it turned out, free prices made rationing obsolete very soon. Finally, imports were governed by a quota system even longer. After the fact, it is clear that almost all domestic price controls and rationing, except perhaps for housing, could have been removed at one stroke.

Turning back to the present Soviet situation, one has to agree that although conditions are certainly no less favorable than in postwar Germany, the necessary reforms may be more complicated because of several factors. First, private property still predominated legally in West Germany after the war, though there were allied controls, a blocking of property owned by the Reich and former Nazis, and a control on the production and sale of coal and steel. Also limitations still existed on industrial production. The problem of reparations and

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of how to pay for the expenses of occupying forces had not been settled. But fundamentally, the motivation to work efficiently and innovatively that is inherent in private property could be brought to work again just by abolishing government regulations and interference. This condition is not true for the Soviet Union, where private ownership of the means of production has been totally abolished and where, ideally, such ownership should be restored before, or together with, reforms as a precondition for success. I will return to this problem later.

Second, West Germany had a developed tax system at its disposal. This system could be used to get sufficient revenues to cover expenses. Also the currency reform ended Soviet capabilities to create German money in their occupation zone so they could cover the army's expenses. We know already that no comparable tax system exists in the Soviet Union. Thus, it is indispensable to introduce simple and strong revenue-generating taxes such as turnover, sales, or, even better, value-added taxes before enacting reform measures to deregulate prices and to create a stable money. On the other hand, removing subsidies to support loss-making enterprises and below-equilibrium prices should occur in conjunction with abolishing price regulations, ending rationing, and removing the monetary overhang.

We now turn to the problem of monetary overhang, which consists mainly of financial assets that are convertible into money at short-term notice and possibly of more limited excessive cash holdings. This monetary overhang can be removed in several ways, though one way seems preferable. The first way is to allow prices to rise, after decontrol, until the real value of money and short-term financial assets have been reduced to amounts corresponding to normal demand. Then no inflationary potential would remain. By referring to the example of Poland, we have already argued that this once-and-for-all increase of the price level, implies serious dangers. The velocity of money may increase significantly, and the Tanzi effect may increase the budget deficit, thus providing new food for ongoing inflation. This process also endangers the necessary development of credit and capital markets. It is well known that in high-inflation countries these markets shrink in volume and in the duration of credits and of financial assets. In the end only very short-term credits with highly fluctuating nominal interest rates are left. Moreover, banking crises are recurrent under these conditions (compare, for example, Machinea and Fanelli 1988 for Argentina). Yugoslavia in 1989 provides an example of a decentralized, more or less socialist market economy with labor-managed firms, where inflation has run out of control (Velimir and Gaspari 1990).

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The second way to remove the monetary overhang is to convert short-term financial assets and the existing excess supply of money into long-term interest-bearing government bonds. This solution can be recommended only if the additional burden of payments for interest and redemption can be financed out of ordinary revenues. Given the situation of the Soviet budget, this solution, like the first, does not seem to be feasible.

A third way to remove the money overhang is to privatize state-owned firms, houses, and apartments by selling them to the public. There are, however, several problems with this solution. First, consumers are interested in buying durable goods after years of scarcity, not shares of firms. Second, even though the chances of selling houses or apartments may be somewhat better, the occupants should have the first choice to buy. But why should they prefer buying an apartment in which they already live at a very low rent instead of buying durable consumer goods? Third, selling loss-making firms or firms with an uncertain future may even be impossible. Moreover, it is not very helpful for the success of reforms to make privatization of firms depend on a difficult and long-lasting selling effort. Finally, the receipts from selling firms and apartments would have to be destroyed or sterilized to get rid of the monetary overhang. Even their use to cover the budget deficit would not be satisfying. True, this use would remove a source for the creation of new money, but the inflationary pressure from the money overhang would persist since the receipts from selling firms, houses, and apartments would now finance government demand.

A fourth way to remove the money overhang would be a currency reform like in the 1948 reform in West Germany. Since the exact magnitude of the overhang is usually not known , a somewhat excessive reduction of the overhang may be preferable, with the possibility of freeing an additional part of the old financial assets later on.

Objections sometimes arise to this fourth alternative. It is argued that a currency reform implies an unjust confiscation of wealth not in conformity with the rule of law. One must, however, realize that there are no consumer goods corresponding to short-term financial assets. But given this objection and the task of privatizing industries and housing, it seems to be advisable to combine a currency reform with the third alternative. This combination of reforms could be done by blocking, say, 90–95 percent of short-term financial assets while, at the same time, allowing them to be used for a limited period to buy shares of firms to be privatized and shares of government-owned flats or houses, preferably by their present occupants. First, a majority of the shares of each firm should be distributed to the workers of

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the respective plants. As compensation, the 250 billion rubles of enterprise deposits, minus the 5–10 percent of those financial assets not blocked, should be canceled. Similarly, households could use the greater part of their blocked savings deposits to buy a flat or a house, along with using any remaining amount to acquire shares not already given to employees. Shares should, after some time, be freely saleable, for example, in the newly founded stock exchanges.

A new money should be introduced together with currency reform. This change would help to convince people that the reform will be a once-and-for-all measure leading to a new era of stability. Finally, as already mentioned, the receipts from the sales of firms, houses, and apartments should be destroyed so as to remove the overhang of money and of short-term financial assets.

Freeing prices; abolishing market controls; and balancing the budget by cutting price subsidies, transfers to loss-making firms, and credits for excessive investments are best initiated together with currency reform. Since a better tax system would have been created before this reform and because price subsidies, as well as many transfers to formerly loss-making firms, would no longer be needed because of price reforms, it would be much easier to balance the budget at the time of reform and thus to stop money creation if all these steps were taken together.

The best moves for controlling the creation of money would be both to confine the central bank by law so that it could buy only gold and foreign exchange, and to grant credit only at positive real interest rates. Such credit would be granted by discounting safe drafts of firms with several signatures, including that of a bank, or by giving loans on securities deposited. A definite money growth rule related to the growth rate of real GNP should be prescribed.

If they were institutionally safeguarded, the reforms would win trustworthiness and long-term durability (Bernholz 1990a). Historical experience proves that monetary regimes based on paper money always show an inflationary bias—if the government has the right to decide on the money supply (Bernholz 1986). If the reform is to counter this tendency, the independence of the central bank and its obligation to secure a stable value of money should be fixed in the constitution. It would also be helpful if the constitution outlawed budget deficits not financed in capital markets and not serving profitable public investments.

Social problems may be caused by reforming the currency, by restructuring the economy, and by the resulting unemployment. To limit these hardships and political resistance against the reforms, some preventive measures are necessary. Before the currency and

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price reforms are undertaken, an obligatory unemployment insurance should be created. Also reformers should ensure in advance that retired persons will receive their retirement benefits after the reforms and that those benefits will be sufficient to provide retirees with an adequate standard of living.

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Strategies for Restoring Financial Stability During the Transition from Plan to Market

Edwin G. Dolan

Peter Bernholz points out that two preconditions must be established to move from a centrally planned economy to one in which decentralized decisions are guided by market prices. These preconditions are (a) the creation of strong, transferable private property rights and (b) the establishment of a sound monetary and financial system. The less-than-complete success of Soviet economic reform to date is arguably due to the absence of these preconditions. Like Bernholz, I will focus my remarks on the second precondition for the transition to a market economy: measures to establish monetary and financial stability. His paper touches on most of the main points that need to be made. I will simply bring certain aspects of the problem of financial reform even more sharply into focus.

Nature and Origins of Repressed Inflation

Equation of Exchange

The problem of financial reform can be restated in terms of the classical equation of exchange. This equation is commonly written in the following form:

$$MV = Py,$$

in which M is the stock of money, V is the income velocity of money (the number of times per year each unit of the money stock is spent for income producing purposes), P is an index of the average price

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The author is an Adjunct Professor of Economics at Gettysburg College and also at the Russian-American Independent University in Moscow.

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level of all goods entering into national product, and y is national product stated in real terms.[1]

Repressed Inflation

To highlight the condition of repressed inflation that has prevailed in the Soviet economy, I will rewrite the equation of exchange to isolate the price level on the left-hand side, as follows:

$$P = \frac{MV}{y} .$$

For any given money stock, there is an equilibrium price level P^* that would emerge given (a) free price formation, (b) a "full employment" or "natural" level of real national product, y^*, and (c) an equilibrium value of velocity, V^*. To say that the Soviet economy is in a state of repressed inflation means that the price level is constrained at a level P_c that is below its equilibrium level P^*. For the equation to balance, velocity must thus be constrained at a level V_c below its equilibrium value V^*. (Velocity will be all the more below its equilibrium value if national product is understood to be below its natural level—a possibility that will be considered later.) To say that velocity is below its equilibrium value, in turn, means that members of the public are holding money balances that, given the current official price level, they would like to exchange for goods and services. But they are unable to spend them because goods and services are not being produced at a sufficient rate.

The situation that I have described in terms of an artificially low value of velocity is more commonly described as one of "monetary overhang." This term, as I understand it, refers to an amount by which the money stock would have to be reduced to permit macroeconomic equilibrium at the prevailing price level. Unfortunately, discussions of the monetary overhang are often flawed in that they fail to specify what assumption is made about the equilibrium level of velocity. For example, some formulations of the problem calculate the overhang

[1]It is far from clear how these items are best defined in the Soviet context. One problem is that the Soviet economy is still to some degree segmented into a household sector and a state enterprise sector between which neither goods nor money flow freely. To the extent that is the case, it is sometimes useful, when discussing the problem of inflation, to apply the equation of exchange to the household sector alone, with M understood as currency plus savings balances owned by households and y understood as real output of consumer goods and services. However, if we look forward to later stages of the reform process in which financial and goods markets are progressively normalized, it makes more sense to think of M as household plus enterprise liquid balances and y as real national product. The present comments are sufficiently general, I think, that these matters can simply be left ambiguous.

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by subtracting the rate of output of goods and services (an annual flow) from the quantity of money in circulation (a stock), thereby making the implicit assumption that the equilibrium value of velocity is unity. The experience of market economies suggests that an equilibrium velocity of unity is unreasonably low. For example, the velocity of M2 in the U.S. economy is about 1.6 and that of the narrower aggregate M1 is about 6. Looking at Soviet experience, I understand that in the early days following the post–World War II currency reform, a velocity of 10 was considered normal for household currency holdings.

To the extent that they implicitly underestimate the equilibrium value of velocity, discussions based on the monetary overhang concept may understate the extent of repressed inflation in the Soviet economy. A numerical example may help. Suppose that the money stock in the hands of consumers is 600 billion rubles, the annual output of consumer goods is 300 billion rubles, and the prevailing price level is given the base value 1. Assuming equilibrium velocity to be 1 would imply a currency overhang of $300 billion and an equilibrium price level of 2. These values further imply that a 100 percent increase in the price level would bring the system into equilibrium. But suppose equilibrium velocity is instead 5. The 600-billion-ruble money stock would then be capable of supporting nominal expenditures of 3,000 billion rubles, implying an equilibrium price level of 10. The degree of repressed inflation would then be ten times greater. I stress this elementary arithmetic simply because it is so often neglected in discussions of the Soviet situation.

Impacts of Economic Reform

So much for what repressed inflation is. The next question is why the problem has been aggravated by perestroika. Bernholz's paper sheds considerable light on this matter. Here, too, I find it helpful to use the equation of exchange to consider how money growth, velocity, and real output may be affected by economic reform.

The primary source of money growth in the Soviet economy has been the central government's budget deficit. The central budget deficit is monetized because of an absence of financial markets through which the necessary funds can be borrowed from the public. The deficit is instead funded by the central bank, which means through additions to the stock of money in circulation. Bernholz gives several reasons why economic reform tends to increase the budget deficit and, hence, the rate of increase of the money stock. One reason is a tax system that relies excessively on appropriation of enterprise profits. Another is political resistance to raising the prices of essential

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goods and services whose production demands increasing subsidies as reforms free the prices of inputs used in their production. Still another is the need to provide an expanding social safety net to protect the elderly and the unemployed against disruptions inherent in economic reform.

Beyond these sources of money growth considered by Bernholz, I would call attention to the additional inflationary potential inherent in reform and in decentralization of the banking system. As the network of independent commercial banks expands and the payments system is monetized, the central bank loses its monopoly both on the issue of credit and the creation of liquid monetary and near-monetary bank deposits. At some point in this process the money stock as presently conceived, which consists of currency and deposit liabilities of the central bank, may become "high-powered money," that is, a monetary base of reserve assets on the strength of which the commercial banking system can issue liquid liabilities of its own. Even before the point is reached at which commercial bank liabilities become a direct means of payment (in the form of accounts that can be transferred from one party to another by check or electronic transfer), easy access to commercial bank credit and the availability of liquid near-monetary assets could enable firms and households to economize on their holdings of conventional central bank money. Such a situation would add to inflationary pressure.

Economic reform can affect the velocity of money. A more efficient payments system is one potential source of an increase in velocity. Moreover, there is the problem that the uncertainties and inflationary expectations that accompany economic reform will increase the perceived opportunity cost of holding money, thus further adding to velocity. Even if reform were carried out in an environment of overall macroeconomic stability, anticipation of an end to subsidies as a necessary component of reform would cause people to attempt to exchange money for goods whose relative prices can be expected to rise as subsidies are eliminated. That tendency alone would boost velocity during the transition period. If, in addition, reform is accompanied by fears of generalized inflation or confiscatory currency reform, the flight from money to goods will be intensified, and velocity will rise still more sharply.

The ultimate goal of reform is to raise the growth rate of real output. But even if no mistakes were made in implementation, it is widely acceptable as inevitable that real output will fall during a transition period as industrial capacity is converted to new uses and as a large percentage of the labor force is retrained and relocated to take new jobs. Any mistakes in the implementation of reform will only increase

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the transitional decline in real output. And, as the equation of exchange makes clear, any decline in real output increases upward pressure on the price level.

Putting these factors together, we see that the reform process increases inflationary pressure in three ways: (a) through an increased rate of money creation, (b) through an increase in velocity, and (c) through a transitional decline in real output.

Strategies for Financial Stabilization

Having used the equation of exchange to illuminate the nature and origins of repressed inflation, we can next use it as a framework for discussing four groups of strategies for restoring financial stability.

The "Fly-Up" Strategy

This strategy treats the money stock and real output as given, frees prices from constraints, and allows velocity and the price level to rise to their equilibrium levels. If successful, the outcome is a brief burst of inflation during which prices "fly up" to their new equilibrium levels and then stabilize.

Strategies for Reducing the Monetary Overhang

The aim of this group of strategies is to reduce the money stock by enough to permit equilibrium at the existing price level, given the current rate of real output and the unconstrained equilibrium value of velocity. One proposed method of absorbing the excess money stock is sale by the government of nonliquid assets—either financial assets like long-term bonds or real assets like housing, land, and shares in industrial firms. An alternative method of absorbing the monetary overhang is confiscatory monetary reform in which a new currency is substituted for the old one at less than a one-for-one ratio for at least some categories of balances.

Strategies for Reducing Equilibrium Velocity

A third approach to stabilization suggested by the equation of exchange would be to reduce the equilibrium value of velocity to its current low, constrained value while holding the price level, the money stock, and real output constant. To do this, one must reduce the perceived opportunity cost of holding money balances. A proposed approach is to exchange current monetary assets (currency and savings account balances) for some sort of "hard ruble" linked to gold or a major world currency. The public would be willing to hold greater nominal quantities of these hard rubles than of the present soft rubles because their future purchasing power would be

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guaranteed. An alternative approach would be to increase the real rate of return on savings balances by indexing their nominal return to the inflation rate.

Supply-Side Strategies

Finally, in principle, the economy could be stabilized on the basis of the existing price level and money stock if real output could be increased in the ratio V^*/V_c This ratio can be termed a supply-side strategy inasmuch as it aims to stabilize the price level by increasing aggregate supply rather than by reducing aggregate demand. Unfortunately, no one seems to know how to bring about a rapid rise in real output while holding prices and the money stock constant. If it were possible to do so, we would not need to treat financial stabilization as a precondition for other aspects of reform, such as decentralization and decontrol of the pricing mechanism. Financial stabilization would instead be the result of such reform.

Implementation of Strategies

Setting this last group of strategies aside, then, let us examine the prospects for implementing the first three strategies for financial stabilization, individually or in combination.

The fly-up strategy is a tempting one, if only because it would be easy to initiate. It requires no positive action on the government's part; the government need only step aside by relinquishing its current control over price formation. Unfortunately, as Bernholz points out, a once-and-for-all jump to an equilibrium price level that is implicit in the current money stock, the equilibrium value of velocity, and the natural level of real output may prove impossible because of certain positive feedback mechanisms that come into play during the transition.[2] As a result of these positive feedback mechanisms, each increment to inflation generates new inflationary pressures so that the process becomes explosive.

[2]A negative feedback mechanism is one in which an increase in variable x causes an increase in variable y; an increase in y, in turn, slows the rate of increase of x. A standard example is a household heating system in which an increase in the rate at which fuel is burned in the furnace increases the temperature of the house, and temperature increase, acting through a thermostat, cuts the rate at which fuel is burned. A positive feedback mechanism is one in which an increase in variable x causes an increase in variable y, and an increase in variable y in turn increases the rate of increase of x. An example is an atomic bomb, in which emission of particles from fission of a uranium atom causes fission of other atoms, thereby increasing the rate of emission of particles. Systems characterized by negative feedback are self-stabilizing. Those characterized by positive feedback are potentially explosive.

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Bernholz identifies three positive feedback mechanisms. The first is that inflation tends to increase the central budget deficit, not just in nominal terms but in real terms as well. In part, this happens because the tax system relies excessively on taxation of profits, which, in turn, are likely to be squeezed as workers try to protect themselves from inflation through wage increases. In part, it happens because inflation raises the costs of maintaining a social safety net for vulnerable strata of the population. And, in part, inflation increases the budget deficit because of the lag between tax assessment and the collection of tax revenues—the Olivera-Tanzi effect that is familiar to students of the Latin American experience. This positive feedback mechanism is completed when the growing deficit is monetized, thus adding to further inflationary pressure.

A second positive feedback mechanism is found in the tendency of inflation to increase velocity at the same time it increases the rate of money growth. This happens because inflation raises the opportunity cost of holding monetary assets. In theory, this feedback mechanism could be broken by full indexation of nominal returns on monetary assets. In practice, however, full indexation is impossible, in part because of the zero nominal return on currency, and in part because of lags in adjusting the nominal returns on savings balances. It is worth noting that these effects have been more severe in the Soviet Union than elsewhere because of the degree to which the payments system has relied on currency and because of the low fixed nominal interest rates paid on savings balances.

A third positive feedback mechanism through which inflation fuels further inflation is the fact that financial instability is likely to disrupt the reform process on the supply side. This instability aggravates the inevitable transitional decline in real output. Consequently, the rate of inflation associated with given rates of change of velocity and with the money stock is further increased.

When these positive feedback mechanisms are taken into account, the fly-up strategy begins to look more like a recipe for hyperinflation than for macroeconomic stabilization. Without prior radical reform of fiscal and monetary institutions, it is simply too dangerous to attempt.

Let us turn, then, to strategies that focus on soaking up the monetary overhang through sales of assets or through confiscatory monetary reform. Their attractiveness lies in the hope of stabilizing the price level at or near its present level, so that the positive feedback mechanisms just discussed do not come into play. These strategies have a serious limitation of their own, however. By their nature, they can be used only once. After the state sells off its assets, it cannot sell

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them off again. And confiscatory monetary reform, if attempted, must be accompanied by assurances that it will not soon be attempted again. Otherwise, the public will lose all confidence in government money as legal tender, and velocity will explode at the first sign of danger.

In short, there is no point in undertaking measures to soak up the monetary overhang until the rate of growth of the money stock can itself be brought under control. Otherwise, the monetary overhang will quickly reappear and policies that could be used to absorb it will no longer be available. Like the fly-up strategy, then, stabilization strategies based on absorption of the monetary overhang can be used only after thoroughgoing reform of fiscal and monetary institutions.

Much the same can be said for strategies that aim to reduce velocity by decreasing the perceived opportunity cost of holding money. Take, for example, the idea of a gold ruble. It is at least imaginable that the public would be willing to hold a stock of gold-backed rubles equal in nominal value to the existing stock of soft rubles, in which case the new currency could be introduced on a one-for-one basis without confiscation. But the effects of even such a radical policy would be short-lived unless it were accompanied by fiscal reforms bringing the government budget deficit under control and by financial reforms including the creation of an independent central bank (or some other mechanism) to constrain the rate of issue of the new currency.

Necessary Institutional Reforms

None of the proposed strategies for monetary stabilization can be successfully implemented without prior institutional reforms. The necessary reforms include the following:

- Pare the expenditure side of the central budget but maintain a social safety net. Military expenditures, foreign aid, and investment projects with long payoffs are among the obvious targets, as are subsidies to all consumer goods that are not on a very short list of absolute essentials.
- Shift the tax system toward consumption or value-added type taxes and away from appropriation of profits, as Bernholz suggests.
- Develop financial institutions of all kinds, including an independent central bank, commercial banks, and securities markets.
- Introduce liquid assets with positive real rates of return. These assets could include savings instruments with indexed nominal

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rates, legalized ownership of foreign currencies and bank deposits, and possibly even a gold-backed ruble.

Only when such reforms have been implemented will it be possible to decontrol wholesale and retail prices (including wages and natural resource prices) without touching off hyperinflation. It will never be possible to predict the exact equilibrium price level until actual decontrol of prices takes place. Some degree of fly-up with a possible overshoot of the new equilibrium is always possible. However, the fly-up will not break through into sustained hyperinflation if institutional reforms have broken the currently existing positive feedback mechanisms and if the new equilibrium price level is not too far above the level prevailing at the moment of decontrol.

Of course, at the same time the indicated monetary and financial reforms are being enacted, equally rapid legal and institutional reforms must be implemented in the area of property rights. Until both of these preconditions have been established, there is no realistic hope for further progress in other areas of economic reform.

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Glasnost and the Knowledge Problem: Rethinking Economic Democracy

Don Lavoie

> Well, we have lived through a year, the state is in our hands; but has it operated the New Economic Policy in the way we wanted in this past year? No. . . . How did it operate? The machine refused to obey the hand that guided it. It was like a car that was going not in the direction the driver desired, but in the direction someone else desired; as if it were being driven by some mysterious, lawless hand, God knows whose, perhaps of a profiteer, or of a private capitalist, or of both.
>
> —V. I. Lenin[1]

Introduction

The "knowledge problem" refers to a classic argument—usually called the "calculation argument"—from the field of comparative economic systems about why centralized planning fails.[2] The argument, to which this paper will return in detail, was initiated in 1920 by the Austrian economist Ludwig von Mises and was sharpened by

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The author is Associate Professor of Economics at the Center for the Study of Market Processes at George Mason University. He wishes to thank Peter Boettke and Kevin Lacobie for their comments on an earlier draft. He also thanks the Earhart Foundation for financial support.

[1]Cited in Lenin ([1922] 1965, p. 279). I thank Peter Boettke for reminding me of this quotation.

[2]For the classic statements of this critique of socialism, see Brutzkus ([1921] 1935); Hayek (1935, 1940); Mises ([1922] 1936). Important interpretations of the critique and its relevance to other issues can be found in Boettke (1990), O'Driscoll (1977), Polanyi (1951), Roberts (1971), and Vaughn (1980). Hayek's own latest statement of his argument (1988) is in my view his best. My own efforts to draw out the lessons of this critique are numerous (Lavoie 1985a, 1986, 1987a, 1987b, 1990). The idea of explicitly relating the knowledge problem argument to democratic processes was suggested to me by Kurt Schuler (1990).

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others, especially his most famous follower, Friedrich A. Hayek.[3] The argument was conceived narrowly and in a negative mode, as a critique of socialist (especially Marxian) economics. But the argument has evolved into a broader knowledge problem concerned with the way decentralized and tacit knowledge gets used in society, and now represents a more positive account of the way economic knowledge is created, discovered, and conveyed in market institutions. The argument contains valuable lessons, not only about why the traditional Soviet-type economy and many attempts to reform it have failed, but also why many more conventional Western-style policies in capitalist economies have been unsatisfactory.

On the other hand, glasnost refers to the new spirit of democracy, the cultural opening up that has been achieved over the past few years in the Soviet Union, in spite of the failure so far of economic reforms.[4] Juxtaposing glasnost with economics (and especially economic calculation), or using the phrase "economic democracy," seems to confuse ideas that belong to completely separate universes. I will try to bring these universes a bit closer together. Perhaps economic questions are being treated too differently from cultural ones. And perhaps this is a source of some economic difficulties that perestroika has had.

Might there be a way to conceive of an economic democracy or "democratic economy," a system of economic production, that is imbued with the open-ended, creative spirit that animates the cultural flourishing of glasnost? Can democratic principles be "radicalized" and extended throughout society and into the very production process of the economy? Can democratic values shape not only the way we exchange words with one another, but also the way we exchange goods and services?

The idea of extending democratic values into the economy is not new. Marxism originally had noble aspirations to what it considered

[3]In the literature the argument generally goes by the name "calculation problem," but I prefer the label "knowledge problem" to stress what has come to be considered the key issue in the argument, the issue Hayek (1937, 1945) was later to call the use of knowledge in society. This argument should not be confused with the political critique that Hayek (1944) is famous for raising against socialism in his classic book *The Road to Serfdom.* In the political argument the issue is "why the worst get on top." For the knowledge problem critique, the issue is why, no matter who is on top, those people cannot really know enough about what is going on "at the bottom" to intelligently run an economic system.

[4]Some Western commentators have pointed out that the word glasnost does not directly translate into "democracy." I will use the two words synonymously because, as I will argue, the Russian word's connotations of openness and publicity are highly evocative of the core idea of democracy.

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a more radical form of democracy, and had its own notion of an economic democracy. Marx considered the political system of "bourgeois democracy" an advance over previous political systems, but ultimately held it in contempt as a pale reflection of what *true* democracy would involve.[5] Socialism would go beyond Western-style representative democracy by extending the application of democratic principles beyond questions of electing supposedly representative government officials and into the whole economy.

In the aftermath of the utter collapse of these ideals, the notion of economic democracy needs to be rethought. Marx's version did raise important questions about the proper scope of democratic values and about the limited extent to which they have been realized in Western capitalist political systems. In my own view, his challenge—that Western politics falls far short of its own democratic ideals—retains much of its validity today.

Marx had reasons to be unsatisfied with the status quo of his day, as we do with ours, but his particular alternative led to a system far worse than he could have imagined. It led to disaster because it had concluded that market institutions were essentially incompatible with democratic values and needed to be replaced by a democratically determined central plan. It is now well understood that in practice these ideals resulted in the destruction of both the Soviet economy and democracy.

The failure of this great experiment in social engineering should not be an excuse, however, for complacency about the traditional Western models of democracy. Socialism was born out of our own Western ideals, especially the package of ideals we associate with the word "democracy." The Soviet-type economy does not have a monopoly on the social-engineering mentality. The collapse of the vision in the East needs to be carefully diagnosed, if we in the West are to be sure we do not (more gradually but just as surely) go down the same road. What was it exactly about this attempt to extend democratic values to the economy that made it fail? The question is not only why Marxian socialism never surpassed the modest degree of democracy attained by most Western societies. The question is: Why did it sink so far below this level of semi-representative democracy that glasnost, the recovery of a moderate degree of democracy, constitutes a stunning democratic advance?

I believe Marxism failed for reasons Mises and Hayek explained in the calculation argument. I interpret the argument in its broader,

[5]For a careful interpretation of the tension in Marx between his advocacy of economic planning and his democratic aspirations, see Prychitko (1991).

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knowledge problem form, as not only decisively refuting traditional socialist economics, but also as challenging many more moderate programs for government control over market processes. Indeed, I think that the argument can be still more broadly interpreted as being relevant not only to purely economic matters, but also to the issue of democracy. The argument suggests an alternative way to extend democratic values to the economy. The upshot of this way of looking at things might be a different perspective on the possibilities for reforming the Soviet-type economy.

Glasnost: Discourse as a Social Learning Process

Glasnost has introduced a spirit of democracy into Soviet society, breathing life into what had become an utterly lifeless system of power politics. Politics has, to some extent at least, come out into the open air. Glasnost has legitimated the idea that government must be answerable to "public opinion," that is, needs to defend itself in an open dialogue in which, in principle, anyone can participate. It includes not only the procedural principle of freedom to vote in elections, but also substantive principles such as freedom of speech and the press. And it has transformed more than politics in the narrow sense of the conduct of government. Not just Soviet politics has risen from the dead. Science, the arts, and almost the whole culture, it seems, have come alive. There is a potent social force at work here.[6]

Yet the economy continues to lie moribund. Amid the exhilarating spirit of renewal in many dimensions of life, the amazing frustrations of economic life continue. Efforts to reform the economy have met with none of the success that the opening up of politics and culture have enjoyed. Glasnost has not corrected the gross irrationalities of the Soviet economy; it has only exposed them to the harsh light of open criticism.[7] Might there be some way to get the economy to flourish the way science, historical research, and culture in general have?

If we are to consider what it would entail to extend the spirit of democracy into the economy, we must be clear about exactly what democracy itself really means. First of all, we need to admit that we in the West have not fully nailed down what democracy means, in

[6]One should not, of course, exaggerate the degree of openness achieved in the political realm. My point is only that relative to economic progress, political gains have been impressive.

[7]The sheer documentation, the bringing into the public, of what has happened in the Soviet economy is itself a major achievement. We know more about the extent to which the Soviet economic system has failed.

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terms of concrete political institutions and policies. While no one can deny that Western capitalist political systems are far more democratic than traditional Communist states, they are still very far from realizing the high aspirations contained in democratic ideals.

Democracy means more than voting. Voting is neither necessary nor sufficient for the emergence of a genuine democratic spirit. Dictatorial regimes can go through the motions of elections but they are not fooling anybody. And it is often possible for the participants to come to a consensus so that voting can be dispensed with. Indeed, voting is a last resort at the end of a larger consensus-forming process. What counts is the degree to which participants in a political process are striving for mutual understanding, a striving that should be suspended precisely when a disputed issue comes to a vote. What makes the process as a whole democratic is not so much the event of voting but the extent to which the prevailing attitudes of the participants are conducive to genuine dialogue. What is distinctively democratic is the nature of the dialogue on the floor before voting, such as the debates in subcommittees, that is, the places where open discourse over important issues is carried on. It is only under the conditions where democratic values are being respected in such dialogues that voting itself can constitute a meaningful act of political participation. What makes the recent elections in the Soviet Union significant is the fact that they constitute the culmination of a public political dialogue.

Western conceptions of democracy tend to see no principled limits to the power of governmental institutions, other than that they gain a degree of attachment to popular legitimacy through occasional elections. The government is supposed to get its endorsement in elections, but then is permitted, in principle, to act in any way it chooses. It can, for example, arbitrarily interfere with the (democratic?) rights of citizens to make market transactions with one another. As a result, Western democracies have burdened their markets with increasingly intrusive governments that make dubious claims to represent the will of the people. The fundamental problems with democratic government as we know it are severe enough to make us wary of taking the Western status quo as any kind of ideal. In particular, the deterioration of our representative governments into narrow special interest politics should serve as a warning to anyone who wants to emulate our system.[8] Reformers can surely aim

[8]See Winiecki (1991) for an account of the way special interests work in the Soviet-type economy, as well as citations to the literature on such problems in the West.

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higher in their democratic aspirations for politics than to merely adopt mainstream Western views.

The aim of this paper is not to delve into the difficult question of how to realize democracy in the political arena. Rather, the aim is to ask two other (probably equally difficult) questions: What is the core meaning of democracy? And what would it mean to achieve it in the economy? Marx was right at least to this extent: Democracy should apply to all of our lives and should not be narrowly conceived as a form of government. The spirit of democracy that animates glasnost applies to much more than political elections and touches on the fundamental principles of interpersonal relations in all aspects of life. It refers not primarily to government, but to politics in the more general, Aristotelian sense.

So what is the core meaning of democracy? What is it, exactly, that makes something, a culture, a discussion, a government, a marketplace, democratic? I think we know better what democracy "in the large" means because of our own experience with it "in the small" in our everyday conversations. We know democratic behavior when we see it close-up in the way people conduct themselves in discussions when they take both their subject matter and one another seriously, and when they seek mutual understanding. Democracy, then, can be usefully defined as that set of attitudes conducive to mutual understanding and an open-ended process of dialogue. The elements of what it takes to achieve mutual understanding have been best articulated, I think, in the branch of philosophy known as hermeneutics.[9]

A good conversation is in many ways the model of what we mean by democracy. There is a certain kind of behavior that is conducive to mutual understanding in face-to-face conversation and that, I think, is the basis of our democratic values. The closer human interaction in any particular group comes to efforts of mutual understanding, the more democratic we tend to consider that group. Any individual institution in which individuals have to talk to one another—the firm,

[9]Hermeneutics is sometimes referred to as the *Verstehen*, or understanding, tradition. Especially important in the contemporary *Verstehen* tradition is the work by Hans-Georg Gadamer (1976, 1982, [1960] 1989). For good general summaries of hermeneutical philosophy, see Linge (1976) and Warnke (1987). This philosophy has been applied to political philosophy along lines similar to my own argument by Madison (1986), Palmer (1991), and Sullivan (1989). The Austrian economist Ludwig von Mises and the great sociologist Max Weber, who were two of the earliest to clearly identify the knowledge problem, were both contributors to the *Verstehen* tradition of German social thought.

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the scientific journal's editorial board, the shop floor, the boardroom—can be more or less democratic in this sense.[10]

We might distinguish in this regard four closely related elements of democratic discourses: "openness," "open-endedness," "autonomy," and "publicness." What makes a discourse democratic is the degree to which participants are truly open to one another. To embrace the spirit of democracy is to learn what it means to be "open," to genuinely listen to what other participants are trying to say. To listen requires that one attempt to hear the truth-claim of the other person's words, to take those words in their most powerful interpretation. Democratic discourse does not imply that one be subservient in any way to the other's perspective. Good conversationalists neither force their own perspective over the discussion nor abdicate their own perspective to it. Instead, what drives the dialogical process is the very process of interplay among divergent perspectives.

"Open-endedness" refers to the processual nature of conversation. It is not because consensus is necessarily achieved that democracy is to be celebrated. A healthy conversation aims at consensus but thrives on disagreement. Whenever consensus does occur on any particular issue, the conversation moves on immediately to the next area of controversy. What we should celebrate about democracy is not that it eliminates social discord, but that it makes discord peaceful and productive instead of destructive. Open disagreement among participants who genuinely strive for agreement is itself the basic virtue of democracy.

"Autonomy" refers to the point that for a conversation to be genuine, the divergent individuals that contribute to it must to some degree treat one another as autonomous agents with their own perspectives. This is not to claim some sort of atomistic separateness among individuals, as is implied in much of neoclassical economics. Humans are, of course, fundamentally social and cultural creatures, utterly dependent on one another and, in particular, on the discourses in which they participate. But for their discursive interactions to work well, individuals must acknowledge the need to follow basic rules that protect one another from domination. The discovery process of explicit dialogue works best where the autonomy of its individual participants is sufficiently respected so that conversation is

[10]The neo-Marxist social theorist Jürgen Habermas (1984) also explores the possibility of consensus-seeking conversation as a model of democratic values, and he has made important contributions to these questions. He seems ultimately, however, to draw conclusions that are in almost the exact opposite direction from those I am suggesting.

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allowed to move with the uncontrolled flow of its own dynamic and is not dominated by any individual. One achieves order not by subsuming these divergent voices into a single voice but by strengthening and supporting the rules that protect this autonomy. The interplay among perspectives must be permitted to evolve in whatever direction the dialogue itself draws the participants; it must never become dominated by any one of them. The truly satisfying discussions are those that are completely out of anyone's control and yet seem headed in a direction in which all of the participants are finding themselves driven.

It is possible for this kind of open-ended dialogical process to work in restricted and limited ways under conditions of secrecy, but for it to take full advantage of its own selective dynamic, conversation must take place out in the open, in public. "Publicness" is required to get the pulling and tugging to come from every interested corner, to expose perspectives to as many potential criticisms as possible, to permit the distinguishing of more-open and less-open participants, and to achieve effective and rapid communication in general.

"Democracy-in-the-large" should be based on, but not equated to, "democracy-in-the-small." A democratic polity is one that permits, and to a relatively large degree is driven by, an overlapping set of mini-democracies, which are open discourses held in public over issues of common concern. Democracy-in-the-large is animated by the same spirit of openness in dialogue as the smaller discourses of which it consists, but unlike them it does not have any specific purposes. Each of the democracies-in-the-small of social life has its own articulated and tacit purposes about which the discourses are engaged. Every conversation has a point. But the conversation of mankind, the set of all the discourses, has no grand purpose of its own. Democratic society as a whole has no particular purpose except to maintain or improve the context that is conducive to the flourishing of the overlapping set of discourses of which it is composed.[11]

I will take these values of openness, open-endedness, autonomy, and publicness as a working definition of democracy. In the large or in the small, democracy has been achieved only incompletely anywhere and, certainly, only very partially in the Soviet Union

[11]The element of open-endedness, or the absence of a need for resolution, is thus especially true for democracy-in-the-large, where there really is no explicit overall purpose that democratic processes need to settle on. An organization needs to settle on a deliberate plan, but a democratic society as a whole ought to be simply a peaceful interplay of the activities of all its participants. Agreement is required, but only about the basic rules of the conversations, not about the specific direction the conversations need take.

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today. Yet I think it is fair to say that glasnost represents the beginning of a truly democratic movement in this sense. Some genuine, open political discourse has been permitted; the lid on public political dialogue has been partly lifted; the autonomy of critical voices has been largely protected; many things long hidden have been made public. The results, achieved only by letting different voices be heard, have been truly astonishing. Glasnost has given birth to a new phenomenon in Soviet society: public opinion. It has generated an open-ended public dialogue, a serious public questioning of the basic orientation of Soviet society, openness that was impossible a short time ago.

What makes democracy so powerful a social force? Perhaps the connection between democratic values and attitudes conducive to mutual understanding is what lies at the root of democracy's potency. Democracy works as well as it does because it encourages a certain kind of communicative/discovery process by which individuals and society learn.

The public dialogue that glasnost unleashed is intrinsically valuable, but it has enormously beneficial side effects. Democracy in science permits the process of open-ended scientific discovery to work. In the arts, it unleashes the creative powers of expression. In politics, public debate permits the imaginative exploration of alternatives in a creative process, so that common social problems can be addressed. Democracy makes a society, as a whole, more intelligent.

I am not referring to the intelligence of individuals in society, but rather to the social use of knowledge. The openness of democratic discussion does not merely permit individuals to learn from one another so that, in some sense, their average intelligence increases. Such openness serves as an engine of "social learning," where new knowledge is embodied in social institutions, tools, and traditions.[12] The contemporary scientist, for example, cannot claim to have an individual intellect that is superior to, say, Leonardo da Vinci. Virtually all our intellectual advantages come from the socially embodied knowledge we can tap into. Openness permits the continuous challenging and improving of our existing stock of socially embodied knowledge.

[12]In Lavoie (1985b, chaps. 2–3), I have elaborated on this idea of "social intelligence," which I derive from contributions by F. A. Hayek and Michael Polanyi on what they called "spontaneous order." See also Salin (1990) for a related discussion of the way that knowledge becomes embodied in tools.

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What is so maddening about undemocratic societies is their inability to honestly identify, much less correct, their institutional stupidities. Though populated by highly intelligent individuals, societies without benefit of an open discourse are systematically stifling their own ability to learn.

Democratic discourse thus serves a knowledge-generating function: It allows for peaceful resolution of disputes and for an evolutionary learning process. Public political dialogue creates and communicates knowledge in a way that the politics of secret intrigue and power cannot. The unhampered give and take during the free exchange of ideas is what brings order to public discussion, not the intelligence of any one person. What makes democracy work is the multiplicity and autonomy of the voices it permits, which propels a rivalrous discovery process among the voices. Our attempts, from our divergent perspectives, to persuade one another result, cumulatively, in a discovery process from which all of us learn.

Not only are the participants to the democratic process interested in *voicing* their own ideas and interests; they are also interested in *acting* on them. It is not only our talk that we would like to make more "socially intelligent"; it is also our activities. Glasnost is nice but it is not enough. The Soviet polity as a whole is getting socially smarter, but despite the undoubted intelligence of its individual participants, its economy desperately needs social learning.

The Knowledge Problem: Markets as a Social Learning Process

Mises's and Hayek's knowledge problem argument can be summed up as a case for why a certain kind of competitive process among private owners of the means of production, which most versions of socialism traditionally sought to abolish or drastically restrict, serves a vital communicative/discovery function for society. Private ownership makes possible a social learning process that takes place by embodying knowledge into the price system. The competitive market process gives rise to prices that reflect knowledge about consumer demands and alternative production possibilities, so that prices approximately reflect the relative scarcities of different goods and services. These scarcity-indicating prices then, through the use of profit-and-loss accounting, inform individual decisionmakers about the relative costs of alternative projects. Thus, more cost-effective alternatives can be found. Profits tell market participants where to find opportunities to improve social coordination, and losses direct them away from unpromising alternatives. Prices act as com-

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municative aids for separated consumers and producers, allowing them to bring their actions into closer harmony with one another.

In other words, market communication is an extension of the democracy of open verbal communication. Just as verbal discourse is a communicative process that must be set free to do its work of discovery, so are markets. The competitive market process tends to weed out less-efficient methods of production in much the same way that open verbal criticism weeds out weaker arguments in science or politics. The very open-ended tugging and pulling of alternative voices, which make a discourse productive of new knowledge, also operate in the "discourse" of market interaction. As with communication in natural language, the market communication process generates true novelty: What can be learned is not necessarily a matter of the capacity of individual human brains, but depends on their modes of influencing one another. It is the fact that the tugging—the efforts of persuasion that pull social outcomes in different directions—is noncoercive, not the specific form of tugging, that gives discourse its creative power. So long as we respect the autonomy of other participants, whether we persuade by words, by example, or by offering something in exchange, we are participating in a creative discovery process.

Our extending to the economy the values that pertain to democracy-in-the-small points in the direction of a free-market system. Openness of verbal discourse has its economic parallel in the principle of free entry in markets.[13] The free market's discovery process is open-ended in the same sense that a conversation is.[14] Property rights and contract law are aimed at defining the boundaries that protect the autonomy of individual actors from infringement by others.[15] Publicness is as vital to the market's communicative function as it is to that of verbal discourse.[16]

Some people think that of all the ways we might influence the production process, the only one that can be considered democratic

[13]See the important work on *Competition and Entrepreneurship* by Israel Kirzner (1973), where the crucial importance of free entry for the working of competition is explained.

[14]The paper "Competition as a Discovery Procedure" by Hayek (1978) concisely elaborates on the open-endedness of the market process.

[15]The classic collection of papers edited by Furubotn and Pejovich (1974) explains the importance of autonomy in the workings of property rights.

[16]It is interesting that the Greek word *agora*, which means a marketplace, connotes these values of openness and publicness. Despite our modern language of the private sector, markets are essentially communicative processes that need to take place in public. Thus, the secrecy required in black markets is one of the key reasons they do not work very effectively.

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is the explicit articulation of one's wants in public discourse.[17] To call for a referendum on whether people want X is supposed to be more democratic than to simply permit them to get X if they want it. But why should people's verbal statements of what they think they want be privileged (as a means of communicating their wants) over other possible communicative methods, for example, their actions as consumers? To widen the notion of democracy to cover more than explicit discourse, we must include a broader range of ways of influencing one another. Democracy must subsume not only the situations of literal dialogues, but also the many ways in modern society in which we are able to communicate at a distance with one another. When applied to our discourse, democracy lets us make verbal transactions with whomever we want to talk to. But if we truly extend democracy to cover the economy, we must be able to make any other kinds of voluntary transactions with whomever we want to. Economic democracy should borrow the core values of democracy but should apply them to both those situations where people exchange words and those where they exchange deeds.

The Mises/Hayek argument makes a case for freeing the communicative/discovery process of markets. For the same reasons that science and the arts should not be under the control of any single institution but should be left to freely evolve, so should markets. Restrictions of free trade obstruct social learning for essentially the same reasons that restrictions of free speech do. Removing obstacles to free-market interaction unleashes the same kind of social power as opening up discourse. The driving engine of intellectual development is freedom of discourse; the driving engine of economic development is freedom of economic action.

What follows from this argument? For one thing, it shatters the original Marxian aspirations for central planning. When Mises first issued the challenge, orthodox Marxism of the kind that inspired Lenin and other Bolsheviks still favored completely abolishing markets, money, prices, profit-and-loss accounting, and so forth, and replacing them with centralized economic planning. Mises showed why markets serve an indispensable cognitive function in social coordination, so that the attempt to abolish markets can lead only to the economy's utter destruction.[18] This is exactly what happened in

[17]I have in mind Habermas and other neo-Marxists who celebrate explicit verbal conversation for its democratic elements, but who see the market as an intrusion on the sphere of verbal discourse. Habermas worries that somehow markets threaten to "colonize the life-world."

[18]See Boettke (1990), Malle (1985), and Roberts (1971) for detailed documentation of the failure of orthodox Marxism in the War Communism period.

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the first few years of Soviet history, when, in the so-called War Communism period, Lenin and other Bolsheviks attempted, on the basis of Marxian principles, to deliberately destroy market relationships.[19]

The Bolsheviks' retreat to the New Economic Program (NEP) signaled the collapse of Marxian aspirations for direct and genuine control over the economy. Instead, Marxians settled for attempts to influence the Soviet economy indirectly by controlling certain monetary and fiscal policy variables, and by securing the "commanding heights." Although the economy recovered dramatically under the NEP policy, Lenin and his followers cannot be said to have learned any lessons from their mistakes. As the quotation at the beginning of this paper shows, Lenin was frustrated by the very success of NEP; the "car" was not doing what he wanted it to do. He had to presume that somebody else, perhaps profiteers, was retaining control. He and his heirs in the Soviet leadership had great difficulty picturing an economy that is orderly and yet is "driven" by no one.

Socialists have scrapped their ambitions of abolishing markets and have reverted to a fall-back position, which is scarcely distinguishable from orthodox Western capitalist public policy. Planning is supposed to indirectly control markets, which are to be viewed as tools by which to steer the economy in desired directions. The specific direction of investment, or which industries are to grow faster, is still considered a matter for government policy to decide. Instead of condemning profit altogether, as Marx did, contemporary advocates of central planning—and most contemporary economic policymakers in the West—ask only that profits be used as explicit incentives by the government to induce individuals to behave in accordance with the plan.[20] Many advocates of reforms today in the Soviet Union seek

[19]Hayek (1935, pp. 33–34) pointed out the "interesting coincidence" that at about the same time Mises first formulated the knowledge problem argument, two other distinguished authors, Max Weber and Boris Brutzkus, independently came to very similar conclusions. One might suppose that the fact that the economic destruction of War Communism was at that very time going on might have had something to do with the coincidence. Weber's brief but lucid comments on the issue can be found in his posthumously published magnum opus, *Economy and Society* ([1921] 1978, pp. 109–13). Brutzkus's whole book, *Economic Planning in Soviet Russia* ([1921] 1935), is an empirical application of essentially the same argument that Mises elaborated on theoretically.

[20]Even orthodox Soviet-type central planning accommodates itself to some elements of markets. Since Lenin abandoned the attempt to destroy markets and introduced the New Economic Policy (NEP), some elements of markets have always been tolerated in the Soviet Union. During NEP, market institutions were in many ways actually encouraged. But since the Stalinist five-year planning system was instituted, they have been permitted only a minimal role. Markets have been constricted, suppressed, distorted, and manipulated, but they have been tolerated to some degree. In the official

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a larger role for markets but still see them as tools to be manipulated by government to bring about specific outcomes. They presume that the economy has been—and should be—under the government's control. They think the government that controls the economy needs itself to be made accountable to democratic forces. The relationship between democracy and the economy is conceived as an external relation, with government serving as a way to steer markets and with democracy serving as a way to steer government.

This retreat from destroying to controlling markets may appear to constitute an answer to the knowledge problem. It recognizes that markets serve certain cognitive functions, among which are the function of providing a way to calculate alternative costs and benefits, as well as a way to give incentives to induce people to behave as desired. The ambition to shape specific details of investment is jettisoned in favor of a more modest goal of shaping the overall direction of investment. Profits are accepted as a necessary means for accounting and as useful tools for psychological motivation.

But the knowledge problem critique cuts deeper than this. I think it not only decisively answers orthodox Marxism; it challenges the whole idea of trying to gain "control," even of an indirect kind, over economic systems. Calculation and incentives are not the most important cognitive functions that profits perform.[21] The crucial function of profits is not to get people to act in a desired way, but to find out what the desired ways of acting are in the first place. The interplay of the market is itself the source of knowledge of what the more effective ways of doing things are, so that for the government to try to guide or steer the market is, in fact, to blindly intervene in a self-ordering process. Neither the specific details of economic investment nor its general direction can be intelligently manipulated by any single will but must result from the free interplay of rival alternatives.

The Mises/Hayek argument shows not only why markets are necessary institutions but also why they are necessarily uncontrollable institutions. Economic planning in the sense of rational control over the economy is not merely inefficient; it is strictly impossible. The process we call a market is too complex to be controlled in any meaningful sense of the term. This is not to say that there is no point to discussing government policy. The effective working of a market

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sector, which is supposed to be under planners' control, prices expressed in money are used, and profit-and-loss accounting at the plant manager's level is required. Significant black and gray markets exist that are outside the official sector and that are not even considered to be under the planners' control.

[21]See Lavoie (1990) for a critique of versions of socialism that identify the cognitive role of profits as strictly a matter of calculation or as a matter of psychological motivation.

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economy depends fundamentally on its being well "cultivated." It should be situated in legal and other institutions that are conducive to its flourishing. Cultivation involves setting in place the background conditions that enhance the market's effectiveness, such as a strictly enforced and well-defined system of property rights and contract law, and a stable money and banking system.[22]

The proper function of government in a free and democratic society should be seen as maintaining and improving the rules by which we live peacefully among one another, not as deliberately carrying out any one person's plan. Policymaking should pay attention to setting up such institutional frameworks in order to get market processes to flourish. But the flourishing itself is a creative discovery process that, like a good conversation, cannot be under any participant's control.

Democratic government should not try to run or steer the market any more than it should try to orchestrate scientific advances, to dictate artistic standards, or to design political discussions. It should just set in place and maintain the legal context that is required for markets to work, in much the same way that it should try to set the context in which political, scientific, and cultural discourse works.[23]

When governments attempt to control economic processes from the top down, what they really do is blindly interfere with a social learning process that they, and the rest of us, need in order to know what we are doing. Planning is impossible, but what is possible and happens all too often is the blind obstruction by governments of order-generating processes that are working from the bottom up.

What, then, is going on in centrally planned economies such as that of the Soviet Union? To be sure, many busy planners are in many different bureaus strewn throughout the economy. Their efforts have an enormous effect on the economy, but is the result anything that could be called effective, rational control over what happens in the economy? Planning bureaus in the Soviet economy are not rationally controlling things but blindly interfering with processes they cannot understand. What is being brought to the economy from the top down is not order but a monstrous degree of interference by planning bureaus in economic life. The limited degree of order that survives this interference is coming from the bottom up. The order that arises in this unusually disorderly economy should be attributed to plant managers and workers in the official sector, and to the gray and black market entrepreneurs, but not to the central planners.

[22]This distinction between control and cultivation comes from Hayek (1955, p. 19).

[23]For an elaboration of this view of the proper role of government as a matter of instituting the "rule of law," see Hayek (1960, 1973, 1976, 1979).

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Things get done at all, when they do, primarily in spite of the interference of the planning apparatus. The traditional Soviet-type economy, though under the influence of many people, is not under anybody's deliberate control, and it could not be.[24]

Government efforts to control markets are irrational for much the same reason that Marxian central planning is: Policymakers simply do not know what they are doing. Markets are not simply convenient things to "have" in the economy, which can be "put to use" in accordance with government's goals. Markets are themselves the source of knowledge of how things can get done at all. The attempt to manipulate markets from the top interferes with the communicative discovery process, so that policymakers cannot know the consequences of their own decisions. The government is not an engineer scientifically controlling the social machinery; it is throwing a money wrench into that machinery.

The real lesson of the classic critique of socialism is that we cannot guide the market process. On the contrary, we need it to guide us. We cannot control it; all we can do is establish the conditions in which it will flourish and then take our own guidance from it. If this argument is correct, then the relationship between democracy and the economy should be reconsidered. What is the point of making government accountable to democratic forces if its efforts to control markets are irrational, futile efforts to control the uncontrollable?

But this argument does not imply that democratic values, properly understood, must be compromised in order to permit the market learning process to work. Such a view would be assuming that markets are a necessary evil and are fundamentally contrary to democratic ideals. The market process, however, is not something that must be brought under anyone's control to be "made" democratic. On the contrary, I am suggesting that open markets should be seen as the very embodiment of democratic values.

This very opposition between democracy and markets is a symptom of an overly narrow conception of democracy. Since democracy is taken to refer only to the conduct of government or, as we say, the "public" sector, we presume it is naturally at odds with the "private" sector. The expansion of democracy into the private sector in this case would involve increasing the ability of the (democratically elected) government to control the market. Democracy is extended only in the sense that the central government institution, which is supposed to receive the stamp of democratic legitimacy, enjoys expanded

[24]See Polanyi (1951) and Roberts (1971) for more of this interpretation of the Soviet-type economy.

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power over other institutions. A more democratic economy would then be one that is to a larger extent under the guidance of the democratic government's policy.[25]

The notion that markets should be under one democratic institution's deliberate control to become democratic is itself a throwback to pre-democratic thinking. If we return to the model of conversation, we see that what makes a discourse democratic is precisely the fact that it is *not* under any participant's control. Just as a good discussion takes on a life of its own and participants are carried along by its flow, so markets constitute an open-ended process with its own systematic dynamic. The attempt to control markets, like traditional central planning, demands a kind of democracy that resolves the divergent perspectives of its members into a single, unified social will, only now the will aims at steering rather than supplanting markets. A more principled approach to democracy should transcend this unification attitude altogether. A democratic polity should not have to melt down the plurality of its voices in order to join in "Grand Social Purposes."

Central planning fails because it neglects an indispensable source of social learning: the competitive market process. This process has been obstructed to some degree everywhere, but it has been seriously crippled in the case of the Soviet Union. Economic reform should open up this source of creativity as quickly as possible.

Conclusion

What implications might this whole way of looking at things have for the question of economic reform? Given how little I know about details of the current political situation in the Soviet Union, it would be presumptuous for me to venture any specific policy advice. But I am suggesting a certain general orientation toward reform. The knowledge problem puts a somewhat different light on the question of what reform really is.

We commonly see the issue of reform presented as a matter of transferring control from one controlling mechanism, the central planning bureau, to another, a monetary and/or fiscal policy bureau. To use Lenin's car metaphor, reform could be said to be analogous to the delicate procedure by which one person might try to hand over the steering wheel of a moving automobile to another person. Somehow, the central planning bureau has to simultaneously let go of the steering wheel, take its feet off the brake and gas pedals, and

[25]From this point of view, were it possible to eliminate markets altogether, that would be the most democratic type of society. In a sense, then, this position retains Marxian socialism as an abstract ideal but admits that it is never fully attainable.

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get out of the way so that new and more enlightened decisionmakers can deftly slip into the economy's driver's seat—all before the car veers off the road. Sounds tricky. In such circumstances caution would seem only reasonable.

But if the argument I have been summarizing is valid, this analogy is all wrong. The only task the central planners should need to achieve is the last one—getting out of the way. If the economy is not now under the planners' effective control and could not be under anyone's control, then reform should not be seen as involving a complicated transfer of control from the center to the periphery. The center never had control; order arises from the periphery. The car steers itself, and the planners' actions are already making it veer off the road. Or to revert to a different analogy, it is primarily a matter of getting the planning bureaus to stop throwing monkey wrenches into the economic machinery.

Does this argument not imply that a policy of gradualism makes little sense? Reformers debate how fast market reform should take place. How fast should we try to get the planning bureaus to stop throwing those monkey wrenches? I think that the economy is in desperate enough straits to demand radical reform toward a free economy and that the speed should be as fast as possible.[26] The knowledge problem, as I see it, lends support to the radical reform wing of the contemporary policy debate.

If markets are communicative/discovery processes akin to democratic discourse, then perhaps government obstacles to free markets have no more justification than obstacles to free speech. It makes no sense to open up free speech only gradually (only for some individuals at first or only for some topics) and it makes as little sense to liberalize only some industries. Only complete freedom will permit these social learning processes to work to their full effectiveness.

Glasnost has succeeded as well as it has because it unleashed engines of human creativity throughout Soviet politics and culture. It did this by simply permitting open political discourse to take place. The point is not to design a procedure to construct democracy, but to get out of the way and let democracy construct itself. Perestroika should be thought of as this kind of open-ended process, which should be fueled by the same spirit of creative experimentation. The central planners should not design the path to a free economy; they should get out of the way.

[26]In most respects I would enthusiastically endorse the platform for rapid reform proposed by the noted expert on Soviet-type economies, János Kornai (1990), who talks of the need for a massive surgical operation.

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A Free-Market Environmental Program

Fred L. Smith, Jr.

The Failure of Political Management

The Soviet Union should not adopt the U.S. approach to protecting the environment. The fact that the United States has a superior environment has far less to do with our Environmental Protection Agency than with our free-market economy. Moreover, the "market failure" thinking implicit in most EPA policies logically implies acceptance of an ecological variant of central planning. As a nation that is only now beginning to escape one long experiment of this type, the Soviet peoples should be careful before beginning another. Not only are the specifics of the American model poorly suited to the Soviet system, but, additionally, the U.S. environmental effort is only some 20 years old; only in the last few years has it received any serious critical attention. That review effort has already suggested major problems with current policy. The Soviet Union faces many economic and environmental problems. A Soviet EPA similar to that in America and given similar powers might well cripple any effort to gain economically. Moreover, there is no guarantee that it would advance environmental values.

Capitalism, Not Political Regulation, Is the First Step

The United States has a superior environment in large part because we have a superior economy. Capitalism demands greater efficiency in the use of energy and material and thus reduces the stress on the environment. Under capitalism, property ownership is more widespread and is more likely to be protected. Capitalism permits people to create wealth and that wealth makes it possible to spend more on environmental issues.

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The author is President of the Competitive Enterprise Institute.

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In the United States, those parts of the economy that are under political control—the highways and airways, many municipal services, national forests—are managed inefficiently and incur large economic and environmental losses. Soil erosion is a small problem in the United States because erosion lowers farming productivity and thus reduces land values. However, erosion is increased by programs that pay farmers to take land out of production and encourage them to farm more intensely that fraction of land kept in production. Moreover, U.S. farm subsidies (an obvious violation of free-market principles) have encouraged the draining of swamps throughout America, destroying ecologically important wetlands. The result is not dissimilar to the diversions of water from the Amu Darya and Syr Darya, which threaten the survival of the Aral Sea.

The Risks of Ecological Central Planning

Consider again the logic of the "market failure" explanation for environmental problems. As generally told, the story goes something like this: Markets are powerful institutions and do many things well. However, markets ignore critical factors such as pollution. Markets fail to produce adequate quantities of "public goods" and they are short-sighted, failing to consider future generations. Since markets fail to address these concerns, political intervention is necessary to correct such "market failures." Fortunately, such intervention is needed only for those parts of the economy having environmental impacts.

There are several problems with this logic. First, the fact that markets "fail" does not, of course, mean that political action will succeed. One must compare the strengths and weaknesses of market versus political approaches before selecting one approach over another. Whereas markets are sometimes less than perfect, the political process is typically a disaster.

Even more important, however, is the fact that the "market failure" model is open-ended. It creates excessive demands on the limited abilities of the political process. It suggests that any economic decision having environmental impacts be regulated. Since, however, every economic decision has some environmental effect, the result is an effort to regulate the whole world. Having rejected central planning for the economy, the United States is now poised to accept central planning for the ecology, an infinitely more difficult task.

Central planning does not work—a lesson that people in the Soviet Union perhaps understand better than people in the United States. Arguments to that effect go back to the 1930s. A political agency lacks the detailed information necessary for proper management and finds

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it difficult to motivate any large fraction of the population to respond to such information as it does possess. These problems of socialism have been empirically and tragically confirmed in recent years. Those concerned with environmental quality should, therefore, reconsider the wisdom of any paradigm that requires such cumbersome political controls.

To be successful, a politicized environmental policy must find some way of setting priorities and of maintaining consistent programs over time. Just as the market continuously decides whether society's interests are best advanced by producing more bread or coal or motion pictures, so also, environmental planners must somehow decide whether more resources should be devoted to reducing nitrogen oxides or expanding elephant populations or picking up litter. But experience teaches us that agencies do not find it easy to set priorities, maintain a program over time, or even allow experimentation.

The U.S. Model Does Not Travel Well

Another reason for rejecting the U.S. model is its inapplicability to the Soviet Union. The American program has involved the expenditure of hundreds of billions of dollars, has relied on a technology-fix approach employing armies of highly trained technicians (both in government and the private sector), has relied on a bureaucracy largely immune to bribery, and has been pushed by an aggressive and independent environmental advocacy movement. While this program has realized some gains, few would argue that the process has been cost effective. The Soviet Union faces many economic problems and cannot waste money in such a fashion. It needs to employ skilled workers in rebuilding the economy, not in designing and maintaining annual improvements in coal-scrubbing technology. Indeed, economic growth is a vital prerequisite to any environmental improvement and that goal must be given priority.

Await the Results of the Review Effort Now Under Way

Finally, the U.S. Environmental Protection Agency is now receiving substantial criticism from both liberals and conservatives. The findings are in general agreement: EPA has sought to do too much and, therefore, has done little well. EPA operates within a political sphere and thus sets priorities to reflect perceptions rather than realities. The result is an emphasis on the sensational rather than on the serious environmental problems. The institutional framework within which EPA operates is not receptive to either scientific or

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economic information, making it very difficult for rational policies to be formulated and implemented.

The EPA has grown into a large and very powerful agency by portraying itself as a public health agency. In reality, the health benefits conveyed by EPA are minimal. Indeed, by raising public concerns over low-level risks and by slowing down the rate of technology change, EPA may well endanger public health. Economic growth and technological development in the Soviet Union have been a political matter for many decades. Suspicion that the risks of such technologies may have been understated seems widespread. To move from a system where information has been suppressed to one that would emphasize every risk associated with technical change would further weaken the prospects for economic and technical growth in the new Soviet Union.

In the Soviet Union, the emphasis on political development has made Soviet citizens suspicious of all change. But where such agencies have been important in the United States—the Corps of Engineers, the Atomic Energy Commission, the Bureau of Reclamation, the Federal Highway Administration—the same type of suspicions have resulted. Fortunately, most economic and technical change in the United States has remained in the private sector where it is better managed. The need to cover costs ensures that projects make economic sense and that liability laws limit environmental and other risks.[1]

However, in the United States such developmental agencies have become less important in the last several decades. Instead, their regulatory sister agencies (the EPA, the Food and Drug Administration, the Federal Trade Commission, the Occupational Safety and Health Administration) that act as gatekeepers, deciding whether a new technology or project goes forward, have become far more important. The bias of such agencies is to retard socially beneficial change. This bias is due to the different incentives of these two types of agencies rather than to the individuals involved. The bureaucrat who gladly assumes developmental risks in one agency can become fanatical about the smallest risks, if transferred to a safety agency.

In brief, the American EPA is not a viable model for the Soviet Union. Rather than adopting this failed strategy, the Soviet peoples

[1]American liability laws are presently in turmoil and similarly provide no good model for the Soviet Union. As later discussed, liability laws should act to clarify property rights and restrict environmental and other trespass. Voluntary (contractual) arrangements permitting the use of one's property would be invoked to resolve "pollution" problems.

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can and should chart an independent course along the free-market environmental lines developed in the next section.

The Case for Free-Market Environmentalism

Rather than Markets Failing, Failing to Allow Markets

The case for market failure seems obvious to many: How can markets address such complex problems as water and air pollution? However, U.S. history suggests an ability to do exactly that. Early in U.S. history, landowners sometimes built dams that flooded upstream users. That flooding, an early form of pollution, was treated as a trespass and the dam builder was forced to lower the dam.[2] Similarly, early steam locomotives spewed forth not only smoke but also sparks. Those sparks sometimes ignited grain fields near the rail tracks. Again, that action was treated as trespass and the railroad was held responsible for damages. Soon, however, the courts shifted (see Horwitz 1977). If property were protected in such ways, the theory suggested, an insurmountable barrier would be created to economic growth and technological change. The "common good" rested on rapid development; thus, the "small" harm to the private landholder was outweighed by the greater overall good to society. This court-driven, utilitarian weakening of property law not only allowed developers to pollute with impunity; it also changed the rules of the game, so that certain participants were allowed to damage the property of others. In such circumstances, to blame the market system for anti-market court decisions is misleading.

The history of the Soviet Union also illustrates the strength of this utilitarian force. In September 1921, Lenin signed a decree entitled "On the Protection of Monuments of Nature, Gardens, and Parks." That decree prohibited any development of natural resources in *zapovedniki* (national parks). The ecological view that environmental amenities should be valued in their own right was popular. In principle, environmentalists would guide and restrain economic growth. In practice, environmental concerns were never well integrated into the Soviet economy. As these guidelines began to conflict with the economic priorities of the Five-Year Plans, the utilitarian view that saw resources solely as raw material for economic growth came to the fore. Only Lenin's personal interest prevented total control by the development-at-any-cost forces. Once the Stalinists came into power in the late 1920s, the utilitarian position became dominant.

[2]This case is discussed in Smith (1982) and DiLorenzo (1990).

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Thus, as the Soviet Union reestablishes the concept of private property, it should return to its own earlier preutilitarian tradition. Only if businesses bear the costs of pollution directly are they likely to respond. In a world where property rights were honored, some sectors might grow more slowly and decisions about location, production, and distribution would change. Most important, incentives would exist for innovations that would reduce pollution. The inclusion of environmental values in the private property regime would yield a different path for economic development, one that would be more sensitive to environmental values. The ingenuity of the nascent Soviet entrepreneur would be harnessed to solve both economic and environmental problems simultaneously.

Although in the United States the first blow against the protection of property rights from pollution was judicial, the legislature soon joined the battle. During the late 19th century, American intellectuals became enamored with the progressive statist policies of Bismarck's Germany. The view that resources were best protected through political action became dominant. America departed from its British antecedents and made all native wildlife the property of the state. However, it was only toward the end of the 19th century that this policy began to dominate the political agenda. The first results were the creation of the national parks and national forests around the turn of the century. Private property, the experts believed, was too likely to be used for narrow special interest purposes; only enlightened management by well-trained public "servants" could ensure that the public interest would be advanced.[3]

In this century, the growing belief in the superiority of political control of resources has led to increasing nationalization throughout the United States. Over one-third of our land is now politically controlled. Only the Soviet Union, China, and a few other nations have a larger share of their land base in the public domain. And only the United States seems to be moving toward increased nationalization. Not only land but other valued resources such as the electromagnetic spectrum became federal property under this collectivist paradigm. With so much of the nation governed in such a fashion, one should not be surprised to find that environmental (and economic) values have done badly. Again, the mismanagement of the public domain reflects more a failure to allow markets than any market failure.

Not only does the federal government own many of America's environmental resources, it also directly competes with—and thus

[3]The resulting political mismanagement of parks and forests has received considerable attention in recent years. For example, see Chase (1986) and O'Toole (1988).

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suppresses—private options. Water supplies, sewage treatment plants, solid waste management services, timber management, recreation—all are areas where the federal government directly competes with private enterprise. Political suppliers of goods and services enjoy certain advantages over private sector alternatives. Political efforts often outlaw or restrict competing private operations. Such public sector monopolies have reduced market experimentation and resulted in few creative solutions to our environmental problems.

Finally, the ability of U.S. markets to resolve environmental issues has been massively curtailed in recent years by the growth of the regulatory state. Today, many of the creative cooperative management arrangements might be ruled illegal under the antitrust regulatory laws. After all, conservation implies reducing output today to ensure a more sustained supply over time. Supply management, however, is suspect under the antitrust laws. In fact, efforts by Gulf Coast shrimpers to moderate their catch and thus conserve this valuable resource were enjoined by the U.S. federal antitrust authorities.[4] Other federal laws such as the Endangered Species Act, for example, make it very difficult for environmental entrepreneurs to expand the supply of rare animals. On the basis of a logic akin to that behind the antitrade policy affecting elephants, U.S. environmentalists drove out endangered species (Simmons 1989). Ideology proved more important than survival.

In summary, although the United States remains in many ways a free-market economy, massive changes have occurred over the last century that greatly impede any private responses to environmental problems. Trespass laws were weakened, making it harder for private parties to protect properties from pollution and reducing the incentives to develop pollution-reducing technologies. Politically controlled property is a dominant feature of the United States; government lands are managed poorly from both an environmental and an economic perspective. State run (and tax-subsidized) waste management enterprises have limited the ability of private firms to address environmental issues. Regulations restricting cooperative arrangements and property use have also weakened the robustness of the marketplace in the environmental area. In the face of these antimarket policies, we must reconsider the market failure thesis. Moreover, markets and other voluntary arrangements already play an important environmental protection role—a role that has received insufficient attention.

[4]For a complete discussion of private alternatives to political management of the ocean, see Jeffreys (1991).

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Markets Already Protect Environmental Values

Some within the environmental community would agree that the political system does not work well. But they doubt whether private property approaches work better. Before considering free-market environmentalism, they demand evidence that a property rights approach can, in fact, advance the full slate of environmental goals. Provide evidence that markets might better protect the elephant, for example, and the discussion switches to the problem of groundwater contamination. Demonstrate that groundwater might better be protected by "unitization,"[5] and environmentalists raise questions about hazardous wastes. Discuss the possibility that hazardous wastes might better be addressed by "private adoption,"[6] and one is tossed the ultimate problem, the dreaded greenhouse catastrophe.[7] For such reasons, it is necessary to discuss in at least some detail the total complex of environmental issues.

That work, unfortunately, has only just begun. Since the dawn of the modern environmental era, there has been no serious attempt to apply the property rights approach in the United States. Most other nations have followed this lead. While thousands of analysts labor to advance political solutions to environmental problems, only a handful of free-market environmentalists yet exist. There is a rich literature on the ways in which various societies have addressed environmental issues,[8] but that research has not yet been applied to modern environmental problems. Most of the research that has been done in this area reviews the record of government agencies acting as resource managers (studies of the U.S. Forest Service, the Bureau of Land Management, the Corps of Engineers, and the World Bank). That work demonstrates that political agencies have a weak environmental record but does nothing to demonstrate that private management would yield a superior outcome.[9]

[5]This common method is utilized for management of oil deposits (discussed later in the paper).

[6]The idea of adopting a hazardous waste site in return for reduced pollution fees. This idea is currently being explored by Richard Stroup of the Political Economy Research Center.

[7]Global issues are among the most difficult of all possible concerns for free-market groups. However, this difficulty does not suggest that socialist solutions would prove superior. An initial suggestion of how to address this issue is discussed later in the paper.

[8]The cultural anthropological literature on this point is quite illuminating. See, for example, McCay and Acheson (1987) and Cordell (1990).

[9]The creativity of private parties in advancing environmental goals has been described in a valuable report contained in *Environmental Quality* (1984), chap. 9.

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An excellent example of how private property better reconciles environmental and economic values is the Rainey Wildlife Refuge. This refuge, owned by a major environmental group, is located in the midst of vast natural gas and oil fields. Since the refuge was privately owned, development was at the discretion of the environmental group, the National Audubon Society. That "purist" attitude, however, would have lost the royalty payments of a producing well. The Society elected to permit drilling under careful guidelines to reduce environmental damage. Economic and environmental gains to all resulted. In contrast, the Audubon Society, along with most other U.S. environmental organizations, vigorously opposes any energy development in the politically controlled Arctic National Wildlife Refuge. Absent a property stake in rational development, there is little reason to be rational.

In a world of private property, unpopular values can be protected. In the political world, a resource can be protected only if it garners sufficient support, generally a majority of the population. The extent of environmental values at risk in the modern world is vast. There are only some 150 governments, many of which now find it hard to protect their citizenry. There are, however, over 5 billion people on this globe. Only if the collective instincts of these peoples—their interests, skills, and wealth—are enlisted in the environmental cause is any appreciable fraction of the biosphere likely to receive adequate protection.

The challenge then is not to restrict markets, to segregate the world economy, but rather to integrate the ecology and the economy. Only if market forces and private property are extended throughout the world will society gain the ability to save nature. Ocean reefs in the South Pacific, Andean mountain tops, elephants in Africa, the shoreline of Lake Baikal—all deserve protection as the private property of some group or individual.

A fishing club, the Pride of Derby, demonstrates how property rights can prevent stream pollution. In England, clubs own the right to fish along some rivers and thus are quick to respond to pollution threats. An upstream municipal polluter argued that its interests outweighed those of the club. Since the fishery was threatened, the club went to court and prevailed. This ability of private parties to restrain municipal polluters in the United States is limited. Under the Clean Water Act, political polluters are treated preferentially. First, their clean-up goals are less stringent; second, they face far more lenient clean-up schedules. To politicians, the source of the pollution is as significant as the pollution itself. Politically preferred

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polluters are treated more leniently than are pariah polluters. Yet, to the river and the fish, pollution is pollution.

Free-market environmentalists see the ability to better enforce the polluter-pays principle as a key element in the environmental movement. Ownership of a pollution-sensitive species can ensure protection of the larger environmental value. By protecting privately owned fishing spots from pollution, the owners protect not only their portion of the river but also downstream areas. Similar ownership rights in oyster or shellfish beds might protect larger lakes and bays. Moreover, these examples suggest that even when one cannot readily envision any way of protecting the total bay or river, partial ownership rights might suffice. Even if only upstream or shoreline areas are privatized, the whole region may be protected.

Groundwater has become one of the more important environmental resources. Over half of all drinking water is now derived from such sources, and there is growing concern that improper management of this resource may lead to excessive depletion and contamination. Free marketeers note that similar problems are solved routinely in the oil industry. Like an aquifer, an oil pool is an underground liquid resource subject to depletion and quality deterioration. To address this problem, the oil industry has developed a property rights restructuring program called "unitization," which entails the assignment of all individual ownership rights to a new entity (the "unit"). The unit manager then operates the field in an integrated fashion for the duration of production. Each owner receives a share of the income of the pool. Unitization illustrates the restructuring of already existing property rights to allow more efficient management. Such reassignments of rights can be an important privatization strategy. With the Soviet Union struggling to modernize its oil industry, private property rights and unitization offer new opportunities for improvement.[10]

Unitization is not always easy. Still, it has been used successfully by the oil industry for many years. As groundwater becomes more valuable, the unitization approach might well be extended to permit private management of groundwater supplies. This example illustrates again the principle that privately owned resources are more likely to be used wisely (Fractor 1982).

Politics or Property Rights: There Is No Third Way

Many would agree that command-and-control regulatory approaches are too costly, but would still reject a property rights

[10]Note that some oil fields are so large that it becomes very difficult, and costly, to reach agreement on a single unit. Nevertheless, this obstacle has been overcome through the development of water-wall "fences" that subdivide the pool into separate units.

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approach. For example, Robert Stavins (1989, p. 96), director for the recent *Project* 88 reports, states:

> Does anyone really believe that acid rain can be efficiently controlled by assigning private property rights for U.S. airshed and then effecting negotiations among all affected parties? Economic-incentive mechanisms, on the other hand, avoid the impracticalities of the pure, private property approach, while retaining the merits of decentralized, market-driven policies.

This statement follows a long tradition of well-respected economists who argue that when markets "fail," political intervention is indeed necessary, but that one need not rely on command-and-control regulation. Rather, one can emulate the role that markets would perform were they available and set the quantity or price of the targeted factor at the appropriate level.

In the environmental area, this "third way" would rely on politically determined pollution taxes and emission rights. Politics will continue to set the output targets, but "market-oriented" policies will get us there. Such approaches have long been championed by economists, but have now received some support from mainstream environmental groups.[11] Unfortunately, such measures are not more likely to prove effective than the more direct political methods they replace. Nor are such approaches really new. In the economic sphere, they were widely championed under the "market socialism" label in the 1930s. Socialist economists had begun to recognize the practical problems of managing a modern economy and advanced this approach as a way of approximating the efficiency advantages of capitalism, while still retaining political control. In the Soviet Union, one advocate of this approach was Evesi Liberman although his efforts are now largely forgotten.[12]

The reasons why market socialism did not work are much the same as those explaining the failure of command socialism and were well explored in the socialist calculation debate of the 1930s between Oskar Lange, the brilliant socialist economist, and Ludwig von Mises and F. A. Hayek, equally brilliant free-market economists. Both sides agreed that a command economy would fail. Lange, however, argued that efficiency could still be attained via a computed system of incentive prices and/or tradeable production quotas. Hayek argued that

[11]For example, the "market-oriented" policies outlined in *Project* 88 (1988, 1990) received the endorsement of the Environmental Defense Fund.

[12]Liberman, who worked at the Kharkov Engineering and Economics Institute, outlined "market-socialist" reforms in the September 9, 1962, issue of *Pravda*. His program called for the evaluation of economic performance on the basis of profitability of the particular enterprise.

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this was impossible, that absent the voluntary exchanges defining the market, the information needed to calculate price and quantity would not exist. In effect, the absence of a market also means that one cannot replicate a market.[13] Intellectually, most agree that the Austrians won the debate. Even Paul Samuelson acknowledged as much: "It was Hayek, with his point about how the market system brings information to bear upon the outcome, who really won the debate."[14] Politically, however, Lange won and the world was forced to endure another half century of socialist miscalculation.

Some advocating this "third way" (Stavins falls into this camp) agree that the more important question for society is not how to do something but rather what is to be done. Since there is no immediate prospect (in the United States, at least) for eliminating political control over environmental questions, we should at least seek to moderate the costs of such interventions. However, such arguments ignore the fact that adopting more effective means of attaining inefficient goals does not make for efficiency. Indeed, such schemes may delay the date when serious reforms will be possible.

Moreover, even on its own terms, the U.S. experience with "market-oriented" environmental tools—bubbles, netting, off-sets—has been of very limited value.[15] Markets in emission rights have long existed but have never flourished. The political realities that make it hard to set standards also make it hard to regulate via market mechanisms. The regulators have defined such markets extremely narrowly and have moved to further restrict them whenever it appeared that they might become popular.[16] Moreover, regulators have ignored the market's need for clarity and stability. Even worse, environmental officials have seen no problem in simply expropriating such emission trading rights, thereby destroying the incentives to lower emissions in the first place. Private parties are unlikely to take seriously property rights that depend on the vagaries of politics.

Free-Market Environmental Policy for the Soviet Union

This last section of the paper outlines a Soviet free-market environmental program. Since the Soviet Union's most important environ-

[13]This debate is discussed in Lavoie (1985).

[14]Cited in Hanke (1985, p. 222).

[15]The literature on this subject often acknowledges that such policies rarely work as intended. The major enthusiasm for this work comes from economists desperately eager to play a more significant role in environmental policy and environmental groups seeking to gain the support of conservatives. In addition to *Project 88* (1988, 1990), see Tietenberg (1985) for a good example.

[16]There has of yet been no detailed review of governmental created markets, but there

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mental goal should be to improve the efficiency of material and energy use, and since such efficiency is possible only within a free-market economy, the first objective must be to privatize the Soviet economy as rapidly as possible. Moreover, only such a first step will make possible the wealth required to clean up the environment. The second step should be to extend property rights to those environmental resources now at risk, to privatize the ecology. Indeed, these steps should be taken simultaneously to ensure that economic development proceeds along paths more compatible with ecological protection.

Both of these steps are difficult. In each case, knowledge is lacking on exactly what actions are most appropriate, there is serious opposition from vested interests, and societal inertia must be overcome. There is one major advantage in the Soviet economic privatization program: The program can be guided by observing the economies of the United States and the other relatively capitalist countries.

However, the Soviet Union faces much greater difficulties in seeking to privatize the ecology. While, as noted earlier, there are numerous examples of how property rights already play an important role in Western environmental protection, there is no obvious role model for this novel approach. No nation has yet sought to integrate its ecology and its economy along free-market lines. This section discusses how this process might begin with wildlife, streams and lakes, and airsheds. The Soviet Union does enjoy one major advantage in this reform effort. Its history ensures that the Soviet peoples be slow to accept the central planning approach inherent in the "market failure" paradigm. Moreover, Soviet society has not yet been captured by a Green Nomenklatura eager to save Nature from Man—at any cost.

Privatizing the Economy

Privatization refers to the transfer of an enterprise or resource from the state to a private party. There now exists a substantial literature on this topic.[17] Others have discussed this traditional privatization process. Their advice is mine—the Soviet Union should privatize its economy as quickly as possible. Speed is far more important than ensuring that the resource goes to the "right" group or is sold at the "correct" price.

The Soviet Union should reinforce this privatization effort by reforming its legal system to reduce its existing utilitarian bias.

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are obvious examples that illustrate the problem: taxicab medallions in New York City and airline slots at congested airports.

[17]Two good examples are Butler (1985) and Fitzgerald (1988).

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Private property means little if it can be seized or expropriated whenever a plausible claim can be made that such actions will advance the "public good." This utilitarian bias in the law has greatly weakened private property defenses in the United States, the consequences of which are only now being seen. The Soviet Union has the opportunity to adopt a rule of law that makes each individual party responsible for the full costs of any damages his or her action imposes on others—that is, to enshrine the polluter-pays principle into law.

Privatizing the Ecology

As noted, there is little precedent for privatizing the vast array of environmental resources that humans have come to value. Nonetheless, there are a few important initial principles. The first concerns the value of an "adoption" statute that would encourage the transfer of environmental resources to private hands. The Zimbabwean law that made it possible for tribal and other groups to petition the state for control over the local wildlife provides one model. The logic of an adoption approach is obvious: Why should the government expend scarce resources to protect a resource that has defenders in the private sector? Hunting clubs, for example, might be granted property rights to a specific forest; a fishing club might recieve rights to the fishing along a specific stretch of the river. Such "parent" organizations would have every incentive to protect these resources and to develop innovative ways of making them more valuable.

The second principle is that environmental issues should be resolved locally whenever possible. Uniform national rules devote too much effort to controlling emissions, resulting in little pollution and too few resources on those rarer, but more serious, problems. Local groups should be empowered to resolve local environmental disputes. Each region should be free to make its own decisions on the appropriate tradeoff between environmental and economic matters.

The third principle emphasizes efforts to simplify the task of determining which polluters are damaging which regions of the country. A property rights–oriented approach would emphasize the need to unravel the complex sequence of events that relate economic activities in one place to environmental damage in another.

The fourth feature of a program to privatize environmental resources concerns the need to improve fencing and trespass enforcement technology. One example—barbed wire fences separating cattle—is indicative of the innovations needed. "Beepers" or implants that would signal the location of larger wildlife (manatees, whales,

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Siberian tigers) might well have value.[18] Technologies also exist making it possible to determine the quantity and types of air pollution entering a region. Lasimetrics, for example, is a technology that can map atmospheric chemical concentrations from orbit. In time, that science might provide a sophisticated means of tracking transnational pollution flows. Note that most nations do participate in "labeling" high explosives manufactured in their countries as part of a world-wide anti-terrorist program.

A primary objective should be to keep things from getting worse, to maintain environmental quality in those areas now in good shape. An approach to that goal would be to encourage hunting and fishing clubs or shellfish or commercial fishing cooperatives to seek title over stretches of forests, rivers, and bays. These groups, like the fishing club discussed earlier in the Pride of Derby example, should be granted full property rights for these purposes and the right to protect their property in the courts. The objective is to place "trip-wires" around the boundaries of areas now pristine to better ensure that they remain so over time.

Much of the Soviet Union is heavily polluted; untreated wastes from many factories and municipalities have already rendered long stretches of rivers and many industrial regions temporarily valueless. In areas badly damaged by air pollution, we might again assign all undeveloped land in the polluted region jointly to the culprit enterprises. The firm would find the value of its newly acquired land varying with its decisions regarding pollution levels. The entrepreneurial firm would find it possible now to make money by upgrading the quality of its holding by reducing pollution. Note also that such incentives depend on the enterprise being in *private* hands; again the first step is to privatize the economy. Contractual obligations enforceable in court would be necessary to prevent firms from selling the land and then returning to their old habits. Moreover, the sales contract might require the firm to add a tracer to its outflow in order to ensure that it continues clean operations.

Urban air pollution control poses one of the most difficult problems to free-market advocates. Conceptually, one can envision ownership of airsheds; practically, there is little understanding of how such properties might be "fenced" or how "trespass" might be detected and prevented. Such problems have led most environmentalists to accept political airshed management. Note, however, that these

[18]The technologies used to protect against shoplifting are suggestive of what is needed, that is, the ability to unobtrusively tag property (in this case, plants or wildlife) in ways that reduce the likelihood of that property being stolen (poached).

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technical difficulties are not made easier by resort to political action. Nor has the performance of the U.S. Environmental Protection Agency in this area been brilliant. Still, a property rights scheme suggests reform efforts.

One such approach would involve the use of automobile emissions charges. The municipalities in which pollution is a problem could test the car to determine its emission profile. This profile could be based on emissions per kilometer, and a windshield or bumper sticker (a red, yellow, or green circle, for example) indicating the emission class of that car could be required. The car's mileage will be recorded and the owner will pay an annual fee based on the miles driven in that pollution class. Since, however, the data suggest that much of the problem occurs because cars for various reasons fall out of tune, there should also be monitoring sites throughout the city (some mobile to catch evaders) to detect any car emitting outside its pollution classification. Violators would pay a fine and move to a higher annual fee category.

This program would encourage owners to maintain their cars more carefully. Moreover, emission performance would become one of the features sought when one bought an auto. If one were driving outside the cities, this feature would not be important; if one were driving solely in cities, one might purchase a tightly controlled vehicle.[19]

The most difficult environmental issues are global, such as the alleged greenhouse warming and ozone depletion. Whether these problems are real or ephemeral is unclear. For many years into the future, the evidence will be ambiguous. Reality, however, is unlikely to make much difference to the policy debate. Despite the evidence to the contrary, many people are convinced that the Earth is warming, that anthropogenic activities have caused that warming, that such changes will have disastrous consequences, and that urgent global political action is needed to save Mother Earth. The major risk today is less global warming than the risks that politicians might adopt anti-growth, anti-energy policies. Support for such apocalyptic policies owes much to quasi-religious environmental groups, government agencies seeking power through greater political control over the economy, and scientists seeking funding.

A new layer of global regulation would be foolish. There is no reason to adopt solutions that will not work—and there is no prospect that international bureaucracies will prove even as reliable as their

[19]This approach is discussed as an alternative to government subsidization of various gasoline-alternative vehicles in Woodlief (1989), and there is a general discussion of this approach in Smith (1989).

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national counterparts. Current advocates are pushing for an international treaty to reduce greenhouse emissions enforced by a tax on all carbon use. A warming phenomenon, in contrast, would benefit some nations, possibly harm others. Why the Soviet Union or Canada would wish to prevent a trend that might lessen the severity of the infamous Russian winter is baffling. Moreover, a tax designed to reduce energy use could do much to weaken the world economy. The data suggest that, while the putative dangers associated with the buildup in carbon dioxide remain undemonstrated, the benefits on agricultural productivity of this carbon dioxide buildup are real and positive.

A free-market approach would consider how property rights might be extended to the atmosphere and how the atmosphere might be protected under the relatively weak rules of international property and liability law. International private law has gradually evolved to allow damage claims against foreign tort-feasors. Case studies are needed of commercial liability treaties dealing with airlines, oil spills, and satellite disasters to determine the extent to which such treaties might be applied to environmental concerns.

Prevention, however, is not the only response to the greenhouse effect. Given the uncertainties inherent in this area, the possibility that this effect might even prove beneficial, and the difficulty in preventing a warming (were it valid), it would be wise to adopt a policy of resilience rather than avoidance. After all, the Earth has survived much warmer periods, and even substantial efforts are only likely to delay rather than prevent these changes. Rather than spend trillions of dollars that might at best delay inevitable changes, a better move would be to deregulate and privatize the economies of the world, reduce the barriers to wealth creation, and thereby make the world more prosperous. Greater wealth would make possible many measures that would make climate change less onerous in any event.

Conclusion

Environmental values are important and should be taken seriously. The question is whether environmental amenities will be considered to be as important as food, clothing, and housing—and thus become integrated into the private economy—or whether they will be viewed as a special category to be produced politically. The Soviet Union can choose a path different from that chosen by the United States.

During the last year, the world was shown dramatic scenes of environmental and economic disasters: dying elephants in Africa, and dying economies throughout the Communist bloc. The causes

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of these disasters were similar: Both the African ecology and the East Bloc economies had been excluded from the world economy. The failures of economic central planning have finally forced reform in the Eastern Bloc. Formerly Communist economies are rapidly being integrated into the world economy. The failures of ecological central planning have not yet triggered similar reforms in the environmental area, but there is hope that the arguments favoring the integration of African wildlife into the world marketplace will eventually prevail.

Both economic and environmental reform are essential. In both cases, the failure to allow the individual to play a positive role has been the core problem. In both cases, no steps were taken to empower people to engage their full energies in the solution of societal problems. The Soviet Union seems poised to enlist those energies in the economic sphere; it also should do so in the environmental field. Free markets provide the means to improve both economically and ecologically. Whether to utilize them or not is the next critical choice for the peoples of the Soviet Union.

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Institutions, Ideology, and Economic Performance

Douglass C. North

The central argument of this essay is that institutions and ideology together shape economic performance. Institutions affect economic performance by determining (along with the technology used) the cost of transacting and producing. Institutions are composed of formal rules, informal constraints, and characteristics of enforcing those constraints. While formal rules can be changed over night by the polity, informal constraints change very slowly. Both are ultimately shaped by people's subjective perceptions of the world around them; those perceptions, in turn, determine explicit choices among formal rules and evolving informal constraints. In succeeding sections I will develop this analytical framework, which I will use to diagnose the contrasting performance of Western market economies with those of Third World and socialist economies.

Institutions and Transaction Costs

Institutions are the rules of the game in a society; more formally, they are the humanly devised constraints that shape human interaction. Thus, they structure incentives in exchange, whether political, social, or economic. Institutional change shapes the way societies evolve through time and, hence, is the key to understanding historical change.

That institutions affect economic performance is hardly controversial. That differential performance of economies over time is fundamentally influenced by the way institutions evolve is also not controversial. Yet Western neoclassical economic theory is devoid of

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The author is the Luce Professor of Law and Liberty in the Department of Economics and Director of the Center of Political Economy at Washington University. This essay is drawn, in part, from North (1990b).

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institutions and, therefore, is of little help in analyzing the underlying sources of economic performance. It would be little exaggeration to say that while neoclassical theory is focused on the operation of efficient markets, few Western economists understand the institutional requirements essential to creating such markets, because they simply take them for granted. Entailed in such markets are both a set of political and economic institutions that provide for low transaction costs and credible commitment that makes possible the efficient factor and product markets underlying economic growth.

Four major variables determine the costliness of transacting in exchange. First is the cost of measuring the valuable attributes of the goods and services or the performance of agents in exchange. Property rights consist of a bundle of rights; to the degree that we cannot measure precisely the valuable attributes of the separable rights being exchanged, then the costs of transacting and the uncertainties associated with transacting rise dramatically. Measurement consists of defining the physical dimensions of the rights exchanged (color, size, weight, number, etc.) along with the property rights dimensions of the exchange (rights defining uses, income to be derived, and alienation). The immense resources that societies devote to organizations and enforcement would be superfluous in a world where measurement costs were zero. But because such costs are extremely high and, in consequence, the rights are imperfectly specified, other variables become important in the cost of transacting.

The second variable in the costliness of the exchange process is the market's size, which determines whether personal or impersonal exchange occurs. In personal exchange, kinship ties, friendship, personal loyalty, and repeat dealings will all play a part in constraining participants' behavior, and they will reduce the need for costly specification and enforcement. By contrast, in impersonal exchange, nothing constrains the parties from taking advantage of each other. Accordingly, the cost of contracting rises with the need for more elaborate specification of the rights exchanged. Effective competition acts as an essential constraint when the parties are engaged in repetitive dealings in impersonal markets.

The third variable is enforcement. In a world of perfect enforcement, ideally, a third party would impartially (and costlessly) evaluate disputes and award compensation to the injured party when contracts are violated. Opportunism, shirking, and cheating would never pay in such a world. But such a world does not exist. Indeed, the creation of a relatively impartial judicial system that enforces agreements has been a critical stumbling block in the path of economic development. In the Western world, the evolution of courts,

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legal systems, and a relatively impartial body of judicial enforcement has played a major role in permitting the development of a complex system of contracting that can extend over time and space—an essential requirement of a world of specialization.

If we retain the neoclassical behavioral assumption of wealth maximization, then these three variables alone will determine the cost of exchange. Thus, individuals would maximize at every margin (if cheating pays, one cheats; if loafing on the job is possible, one loafs; if one could with impunity burn down a competitor, one would do so). But it is hard to imagine that complex exchange and organization would be possible if this assumption accurately described human behavior. The costliness of measuring performance, of fulfilling contracts, and of enforcing agreements would foreclose a world of specialization and division of labor. But ideological attitudes and perceptions (the fourth variable) matter.

Ideology not only plays an essential role in political choices (see North 1990a) but also is a key to individual choices that affect economic performance. Individual perceptions about the fairness and justice of the rules of the game obviously affect performance. Otherwise, we would be at a loss to explain a good deal of schooling, as well as the immense investment made by politicians, employers, labor leaders, and others in trying to convince participants of the fairness or unfairness of contractual arrangements. The importance of ideology is a direct function of the degree to which the measurement and enforcement of contracts is costly. If measuring and enforcing contract performance can be done at low cost, then it makes very little difference whether people believe the rules of the game are fair or unfair. But because measurement and enforcement are costly, ideology matters.

Adaptive Efficiency

Efficient markets are a consequence of institutions that provide low-cost measurement and enforcement of contracts. This outcome is accomplished by rules that encourage adaptive efficiency, by complementary informal constraints, and by effective enforcement. I shall take each in turn.

Adaptively efficient rules provide incentives for the acquisition of knowledge and learning, induce innovation, and encourage risk taking and creative activity. In a world of uncertainty no one knows the correct solution to the problems we confront, as Friedrich Hayek has persuasively argued. Therefore, rules should encourage trials and eliminate errors. A logical corollary is decentralized decision-

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making that will allow a society to explore many alternative ways to solve problems. It is equally important to learn from and eliminate failures. The rules, therefore, must encompass bankruptcy laws and provide incentives to encourage decentralized decisionmaking and effective competitive markets, as well as provide low-cost measurement of property rights.

Formal rules are only part of the institutional matrix. They must be complemented by informal constraints—extensions, elaborations, and qualifications of rules that solve innumerable exchange problems not completely covered by formal rules and that have tenacious survival ability. Informal rules allow people to go about the everyday process of making exchanges without having to think out, exactly at each point and in each instance, the terms of exchange. Routines, customs, traditions, and culture are words we use to denote the persistence of informal rules or constraints. They include (a) conventions that evolve as solutions to coordination problems and that all parties are interested in having maintained, (b) norms of behavior that are recognized standards of conduct, and (c) self-imposed codes of conduct such as standards of honesty or integrity. Conventions are self-enforcing. Norms of behavior are enforced by a second party (retaliation) or by a third party (societal sanctions or coercive authority); their effectiveness depends on the effectiveness of enforcement.

Self-imposed codes of conduct, unlike conventions and norms of behavior, do not obviously entail wealth maximizing behavior but rather entail the sacrifice of wealth or income for other values. Their importance in constraining choices is the subject of substantial controversy—for example, in modeling voting behavior in the U.S. Congress (Kalt and Zupan 1984). Most of the controversy has missed the crucial reason why such behavior can be and is important: Formal institutions (rules) frequently deliberately, sometimes accidentally, lower the costs to individuals of such behavior and can make their normative standards, which are embodied in self-imposed codes of conduct, matter a great deal. Individual votes do not (usually) matter individually, but in the aggregate they shape the political world of democratic polities and cost the voter very little. By strategic voting, legislators commonly find ways to vote their personal preferences rather than those of the electorate (Denzau, Riker, and Shepsle 1985). Judges with lifetime tenure are deliberately shielded from interest group pressures so that they can make decisions on the basis of their interpretation (subjective models) of the law. In each case the choices that were made may be different from what they would be if the individual bore the full cost that resulted from these actions. The lower the cost we incur for our convictions (ideas, dogmas,

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prejudices), the more they contribute to outcomes (for empirical evidence, see Nelson and Silberberg 1987).

How effectively agreements are enforced is the single most important determinant of economic performance. The ability to enforce agreements across time and space is the central underpinning of efficient markets. On the surface such enforcement would appear to be an easy requirement to fulfill. All one needs is an effective, impartial system of laws and courts for the enforcement of formal rules, for the "correct" societal sanctions to enforce norms of behavior, and for strong normative personal standards of honesty and integrity to undergird self-imposed standards of behavior. The creation and enforcement of efficient property rights depend on the polity. However, it is difficult if not impossible to derive a model of a polity that produces such results as long as one retains the standard wealth maximization postulate and accepts the time horizons that characterize political decisions.

Modern Technology and Organization

The preceding paragraph highlights the major dilemma resulting from the revolutionary modern technology that underlies contemporary economic growth. It is easy to devise a set of property rights that, if enforced at low cost, would create an adaptively efficient economy. But as briefly noted earlier, the costs of measuring and enforcing agreements are fundamentally influenced by the informal constraints in an economy. This phenomenon occurs because the economies of scale of modern technology, which can be realized only by specialization and division of labor and of national and international markets, entail impersonal exchange. In such an exchange the parties are no longer constrained by forces that cement agreements in personal exchange—loyalty, kinship, reciprocity, and clientization. Moreover, the gains from defection, to use game theory terminology, rise dramatically. They rise because the gains from cheating, shirking, and stealing rise as well as the costs of monitoring and measuring performance.

The 19th-century revolution in technology fundamentally altered the performance of those economies that would take advantage of the new technology. This second economic revolution has equally radical implications for the organization of societies.[1]

The term "economic revolution" is intended to describe three distinct changes in an economic system: (1) a change in the produc-

[1]The first economic revolution was the development of agriculture, which is believed to have begun in the eighth millennium B.C. in Mesopotamia.

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tive potential of a society, which is a consequence of (2) a basic change in the stock of knowledge, and which entails (3) an equally basic change in organization to realize that productive potential. The change in the productive potential came about in the last half of the 19th century as a consequence of changes in the stock of knowledge arising from the development and implementation of modern scientific disciplines. These changes caused the systematic wedding of science and technology. The technology that characterized this revolution was one in which there were significant indivisibilities in the production process and large fixed-capital investment. The overall implications for economies that could take advantage of this technology were increasing returns and consequent high rates of economic growth; these features have characterized the Western world for the past century and a half.

To take advantage of this technology and realize this potential entailed fundamental reorganization of economies. In those Western economies that have, at least partially, realized the potential, the result has been stresses and strains that have threatened and do threaten their continued adaptive efficiency. For the remaining countries, the inability to reorganize has prevented them from realizing this productive potential and has produced underdevelopment and political instability. It is an extraordinary irony that Karl Marx, who first pointed out the necessity of restructuring societies to realize the potential of a new technology, should have been responsible for creating economies that have foundered on this precise issue. We will examine the microlevel characteristics of the organizational requirements before turning to the macrolevel implications.

Realizing the gains from a world of specialization requires occupational and territorial specialization on an unprecedented scale; consequently, the number of exchanges grows exponentially. To realize the gains from the productive potential associated with a technology of increasing returns, one has to invest enormous resources in transacting. In the United States, for example, the labor force grew from 29 million to 80 million between 1900 and 1970. During that period, production workers increased from 10 million to 29 million, and white collar workers (the majority of whom are engaged in transacting) rose from 5 million to 38 million. In 1970 the transaction sector (that part of transaction costs that goes through the market) made up 45 percent of GNP (Wallis and North 1986).

Let me briefly describe some measurement and enforcement problems that underlie the size of the transaction sector. Control over quality in the lengthening production chain and a solution to problems of increasingly costly principal/agent relationships are neces-

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sary for realizing gains in a world of specialization. Much technology has been designed to reduce transaction costs by substituting capital for labor or by reducing the worker's degrees of freedom in the production process and by automatically measuring the quality of intermediate goods. An underlying problem has been that of measuring inputs and outputs so that one could ascertain the contribution of individual factors, the output at successive stages of production, and the final outcomes. For inputs, there was no agreed-upon measure of the contribution of an individual input. Equally, there was room for conflict over the consequent payment to factors of production. For outputs, there was not only residual unpriced output (waste and pollutants) but also complicated costs of specifying the desired properties of the goods and services produced at each stage in the production process.

Another characteristic of this new technology was that one had large fixed-capital investments with a long life and a low alternative scrap value. As a result the exchange process embodied in contracts had to be extended over long periods, which entailed uncertainty about prices and costs plus the possibilities for opportunistic behavior by one party or the other in exchange. A number of organizational dilemmas have resulted from these problems.

First, increased resources are necessary to measure the quality of output. Sorting, grading, labeling, trade marks, warranties, and licensing are all, albeit costly and imperfect, devices to measure the characteristics of goods and services. Despite their existence the dissipation of income is evident all around us in the difficulties of measuring automobile repairs, of evaluating the safety characteristics of products or the quality of medical services, or of measuring educational output.

Second, while team production permits economies of scale, it does so at the cost of worker alienation and shirking. The discipline of the factory is nothing more than a response to the control problem of shirking in team production. From the employer's perspective, discipline consists of rules, regulations, incentives, and punishment essential to an effective performance. Innovations such as time and motion studies are methods of measuring individual performance. From the worker's viewpoint, these methods are inhuman devices to foster speed-ups and exploitation. Since there is no agreed-upon measure of output that constitutes contract performance, both are right.

Third, the potential gains from opportunistic behavior increase and lead to strategic behavior both in the firm (such as labor-employer relations) and in contractual behavior between firms. Everywhere in

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factor and product markets, the gains from withholding services or altering the terms of agreement at strategic points offer large potential gains.

Fourth, the development of large-scale hierarchies produce familiar problems of bureaucracy. The multiplication of rules and regulations inside large organizations to control shirking and principal/agent problems result in rigidities, income dissipation, and loss of the flexibility essential to adaptive efficiency.

Finally are the external effects: the unpriced costs reflected in the modern environmental crisis. The interdependence of a world of specialization and division of labor increases exponentially the imposition of costs on third parties.

Adaptive Efficiency and Modern Technology

Marxists would contend that these problems are a consequence of capitalism and that the inherent contradictions between the new technology and the consequent organization of capitalism would lead to its demise. But Marxists are wrong; these problems are ubiquitous to any society that attempts to adopt the technology of the second economic revolution. However, as I have attempted to make clear, Marxists are correct in seeing a fundamental dilemma in the tensions arising between the new technology and organization. These tensions have been solved only very partially in the market economies of the Western world. The technology of the second economic revolution, the resulting enormous increase in specialization and division of labor, and the consequent radical alteration of relative prices have altered the traditional structure of society—not only the organization of the economy, but also that of the family and the polity. The growth of government, the disintegration of the family, and the incentive incompatibilities of many modern political and economic hierarchical organizations are all symptoms of the consequent problems besetting Western economies.

However, it has been the relative flexibility of Western institutions—both economic and political—that has been the mitigating factor in dealing with these problems. Adaptive efficiency, while far from perfect in the Western world, accounts for the degree of success that such institutions have experienced. The basic institutional framework has encouraged the development of political and economic organizations that have replaced (however imperfectly) the traditional functions of the family; mitigated the insecurity associated with a world of specialization; evolved flexible economic organization that resolved some incentive incompatibilities of hierarchies

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and that encouraged creative entrepreneurial talent; and tackled (again very imperfectly) the external effects that are not only environmental but also social in an urban world.

It is easy in the abstract to state the conditions that underlie adaptive efficiency. They consist of formal rules (both political and economic) that result in well-specified property rights, effective competition, decentralized decisionmaking, and elimination of failures. But such formal rules by themselves are no guarantee of adaptive efficiency. After all, many Latin American economies adopted the U.S. Constitution (or variants thereof) when they became independent; many economies have copied Western legal systems. In fact, the simple-minded notion that "privatization" is all that is needed to set faltering and failed economies on the path to growth is a travesty of institutional reasoning that reflects the primitive understanding of most economists about economic history and growth. Creating efficient factor and product markets is a complicated process about which we know all too little. But the one thing we do know is that formal rules must be complemented by informal constraints and effective enforcement to produce such markets. Shaping the choices about formal rules that a society adopts, the complementarity of informal contraints, and the effectiveness of enforcement are the subjective frameworks that individuals employ to explain the world around them.

Ideology, Choices, and Adaptive Efficiency

Ideologies underlie the subjective frameworks that individuals possess to explain the world around them. Ideologies contain an essential normative element; that is, they explain both the way the world is and the way it ought to be. While subjective models may be, and usually are, a hodgepodge of beliefs, dogmas, sound theories, and myths, there are usually elements of an organized structure that make them an economizing device for receiving and interpreting information.

Ideology plays no role in neoclassical economic theory. Rational choice models assume that the actors possess correct models by which to interpret the world around them or receive feedback of information that will lead them to revise and correct their initially incorrect models. Actors and their organizations that fail to revise their models will perish in the competitive markets that characterize societies. At issue is the feedback of information that will lead individuals to update their subjective models. If, in fact, the instrumental rationality postulate of economic theory were correct, we would

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anticipate that false theories would be discarded and, to the extent that wealth maximizing was a basic behavioral trait of human beings, that economic growth would be a universal feature of economies. With a sufficiently long time horizon, that conclusion may be true, but in 10,000 years of human economic history we are still a long way from universal economic growth. The plain fact is that we do not possess the information to update our subjective theories to arrive at one true theory; in consequence no one equilibrium is the outcome; rather, multiple equilibria exist that can take us in many directions including stagnation and decline of economies. Ideology matters. But where do individuals' subjective models come from and how do they get altered?

The subjective models that individuals use to decipher the environment are partly a consequence of the growth and transmission of scientific knowledge and partly a consequence of socially transmitted knowledge that is the cultural heritage of every society. To the extent that the former type of knowledge determines choices, an instrumental rationality approach is the correct one in analyzing economic performance. But from the beginning of human socialization, people have created myths, taboos, religions, and dogmas to account for much of their environment that defied scientific explanation. They still do. Culture is more than a blending of different kinds of knowledge; it is value-laden with standards of behavior that have evolved to solve exchange problems (be they social, political, or economic). In all societies there evolves an informal framework to structure human interaction. This framework is the basic "capital stock" that defines the culture of a society. Culture, then, provides a language-based conceptual framework for encoding and interpreting the information that the senses present to the brain. As a consequence, culture not only plays a role in shaping the formal rules but also underlies the informal constraints that are a part of the makeup of institutions.

The ideological constructs that individuals possess to explain their environment do change. These constructs are clearly influenced by fundamental changes in relative prices, which result in persistent inconsistency between the perceived outcomes and the outcomes predicted by the subjective models that individuals possess. But that is not all. Ideas matter; what accounts for the evolving subjective models that shape choices in a society is the combination of changes in relative prices filtered through the culturally conditioned ideas that are generated.

The second economic revolution induced an equal revolution in individual perceptions. It questioned many traditional values and beliefs that had been associated with the traditional role of family,

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polity, and economic organization. The intellectual ferment of the past century and a half, including the diverse perceptions of economists from Marx to Keynes to Hayek, has been an integral part of this change in perceptions that has, in turn, shaped the ideological constructs and, therefore, the players' choices. But neither the constructs of economists nor the subjective perceptions of those making choices over political and economic institutions have been independent of the evolving external political and economic environment. Or to restate my earlier proposition, what shapes the evolving subjective models that humans use to make choices is the interplay among the evolution of culturally conditioned ideas, the contraints imposed by the existing institutional framework, and the consistency or inconsistency between perceived and predicted outcomes.

What characterizes the Western world is the institutional framework of market economies, which have adjusted to partially resolve the costs associated with the second economic revolution and have permitted the productive potential of the new technology to create high-income economies. For the Third World and socialist economies, the consequences of the institutional framework have been to incur the costs of the second economic revolution and to realize only very partially the productive potential of new technology.

The dramatic fall in information costs associated with this modern technology not only has sharpened the perceived inconsistencies between predicted outcomes and observed results, but also has made people acutely aware of alternative models that exist and that appear to offer improved solutions to economic problems. It is one thing to become disenchanted with the old subjective models that one has used; it is much more difficult to arrive at a new equilibrium in the context of rapidly changing external events. Feedback of information produces confused signals that can be interpreted differently by different individuals and groups. The reason for the confusion is the difficulty of fundamentally altering the path of an economy. An economy's organizations and the interest groups they produce are a consequence of the opportunity set provided by the existing institutional framework. The resulting network externalities reflect the symbiotic interdependence among the existing rules, the complementary informal constraints, and the interests of those members of organizations created as a consequence of the institutional framework.

A change in subjective perceptions about the efficacy of the existing framework will produce political and social fragmentation and political instability. For example, a change in the formal rules and, specifically, in property rights must be complemented by consistent informal constraints and effective enforcement to produce the

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desired results. But norms of behavior, conventions, and self-imposed codes of conduct change very slowly; moreover, enforcement would have to, at least partially, be undertaken by organizations and interest groups whose interests rested with the old institutional matrix.

A new, stable equilibrium would be one that produces new informal constraints (conventions, norms of behavior, and self-imposed codes of conduct) that solve the new problems of political, social, and economic interaction that emerge and are complementary to the new, formal rules that are devised.

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Institutional Development in the USSR

Vitali Naishul

Douglass North's paper deals with the frequently underrated impact of social institutions on the economic performance of market systems. It is difficult to disagree with his conclusions, which demonstrate, in particular, that the task of building a national market economy simply cannot be achieved by copying foreign models—no matter how brilliant—and that underlying the surface of rational market behavior there is usually a deep layer of informal (often unconscious) habits, customs, and norms that, in fact, make the functioning of the market possible.

In my commentary, I will not attempt to bolster North's arguments on the market impact of social institutions; instead, I will apply his analysis to the specific conditions of the modern Soviet economy and examine the emerging economic structure.[1]

The Administrative Command Economy and the Administrative Market

It is commonly held that prior to the Gorbachev reforms, the Soviet economy was run—and, to some extent, still is—by the administrative command system. Accordingly, it is believed that the task of "progressive" reformers is to transform the command economy into a market economy.

People who are actually familiar with planning practices in the USSR realize that this widespread view is incorrect. From the 1960s onward, the Soviet Union was a country with a market economy.

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The author is a Senior Researcher at the Institute of Economics and Forecasting. He previously conducted research at the Central Economic-Mathematical Institute of the Academy of Sciences of the USSR and the Institute of Economics of the State Planning Committee of the Council of Ministers of the USSR.

[1]For a detailed discussion of the emerging economic structure in the USSR, see Naishul (1991).

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However, the market that functioned in it was not an ordinary market but an *administrative* one (or, to use James Buchanan's term, a *bureaucratic* market). The administrative command system as the dominant system of economic governance really existed only in Stalin's lifetime. And even then, it existed in its pure form only in high-priority sectors: heavy industry and the military. As the economy grew more complex, management systems became less command-oriented and assumed characteristics of a *contractual* economy.

The typical pattern of administrative market interaction in the Brezhnev era was as follows. Enterprises made requests for resources, which accumulated as they moved up the administrative ladder until they reached an agency authorized to assign production tasks to producers. Then, tasks were distributed among manufacturing enterprises, which responded with new requests for necessary supplies, so that the planning cycle repeated itself over and over again. Brezhnev-era economic planning started *from the bottom up*, not from the top down as under Stalin; its nature was not directive but iterative or cyclical. The "upward" movement of each request for materials and the "downward" movement of each production task was accompanied by furious *bargaining* between superiors and subordinates trying to achieve maximum resource allocation and minimal production tasks.

Since the organizational capacity of the vertical bargaining system was inadequate, the social system was forced to tolerate legal, management-legalized, or simply illegal horizontal exchanges whose importance constantly increased as the economy grew more complex.

The results of both vertical and horizontal bargaining depended, to a large extent, on the characteristics of the partners: their power, their bureaucratic leverage, and their ability to bypass and break laws. Therefore, in a highly developed administrative market, there was trade not only in goods and services but in everything that has value in a hierarchical society: power and subordination, laws and the right to disregard them, diplomas, and social position.

The bureaucratic trade based on status and hierarchy of power ultimately began to sell itself as well by trading in status and power. As a result, the institution of subordination in society began to disintegrate rapidly. In most spheres of activity, it was replaced by short-term contractual relations: "You scratch my back; I'll scratch yours," which leading Soviet sociologist S. Kordonsky astutely labeled "exchange relations." Interestingly enough, such relations—founded, moreover, on contracts that had to be made anew on an almost daily basis—were able to penetrate even into the kinds of enterprises where, in any other country, subordination reigns. What

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is even more important is that these relations paralyzed the normal performance of regulatory government services that function in contemporary Western countries traditionally called capitalist.

Comprehensive exchange relations will ultimately trade away whatever is left of administrative regulation in Soviet society. They will accomplish a drastic deregulation of the economy—something that, so far, only a strong executive power in Chile has been able to do—and accomplish it in a decentralized manner. In the USSR, the future belongs to a market more liberal than in the West.

The Regional Barter Market

As a result of the "diffusion" of vertical relations, their significance kept declining, while that of horizontal relations grew. Gorbachev's political reforms, which allowed the popular resentment against the Soviet regime to spill out, led to an accelerated degradation of vertical connections.

Even as the socialist system in the Soviet Union disintegrates, virtually all organic memory of life before socialism has been erased from the collective consciousness of the people. The peoples of the USSR—Russia in particular—have retained virtually none of the habits that make the "stateless" flow of economic life possible in other countries. Only the vaguest notions of the future economic mechanism, of the structure of a market economy, exist in our society. This means a lengthy and painful search for paths leading back to a normal economic condition.

As a consequence of decades of totalitarian rule accompanied by suppression of truthful information, society has now proved unable to comprehend its present condition. Even the most "progressive" reformers view society as it was depicted for so long by official propaganda, and they are far from understanding the real processes of social life. For instance, it is revealing that Soviet people, who are far less inclined than Westerners to obey the higher-ups and who used to bargain with them constantly on every point, sincerely believe that modern Soviet society is, in essence, a command system. The bottom line is that all the projects of perestroika, including the 500-Day Plan, were projects for introducing a fairy-tale market in a fantasy land.

Yet self-contradictory, chaotically adopted, and unrealistic laws result in a legal indeterminacy that allows individuals and organizations to exercise economic freedoms. When it comes to law enforcement, the weakness of the state generates additional freedoms, since the prohibitive aspects of laws are bent or ignored and only the

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permissive aspects are implemented, as long as they are not at variance with the logic of actual interaction between economic agents.

Near the end of 1990, when the old system of vertical interactions was on the verge of collapse, it seemed that the country stood on the brink of chaos and anarchy. Both the government and the "democrats" began to speak of the need for urgent measures to avoid an acute crisis. And a way out was found—not, however, by directives "from the top," where all was consumed by endless political feuds, but because, amazingly, a system of exchange viable under these difficult circumstances had emerged "from below"—a regional barter market.

The replacement of older economic relations with barter rather than an ordinary money-based economy was determined by several important factors. Under socialism, there was never any money in the Western sense of the word—money that could be used as a universal tool of exchange. Instead, there were special types of pseudo-money, very limited in its functions. *Cash money* could be used only for the purchase of certain consumer goods by the population. It was turned over to banks by the shops and issued by the banks to enterprises for salary payments to employees. In the industrial sphere, *noncash money* was used, essentially of the sane nature as the internal accounts of large Western corporations—that is, it performed primarily an accounting function. It is important to realize that there was a great variety of types of noncash money, since accounts of different types were not mutually convertible. Finally, lack of money in an enterprise's account did not translate into lack of smooth access to goods, while possession of money—cash or noncash—in no way entitled an enterprise to acquire necessary consumer or industrial goods.

The absence of real money with real value led to the proliferation of barter relations, which, however, engendered a number of highly specific problems. In a barter market, as we know, getting what you need is not that easy. To survive in such conditions, enterprises today are not merely trading directly among themselves but uniting into regional power centers that force other power centers to supply the full quota of necessary products. The operating principle is: "Give us what we need or we won't give you anything." In Soviet conditions, great multitudes of goods have only one monopolistic producer, while the suppliers of virtually every enterprise are scattered all over the country. The mutual dependence of all enterprises on every enterprise allowed an expansion of barter trade, which, so far, has caused only a slight reduction in the general volume of output.

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The new, barter-based market economy has given the impetus to a rather harsh structural transformation of the economy. Regions that produce universally needed goods—foodstuffs, fuel, paper, or car tires—as well as export goods not controlled by the central government find themselves at the greatest advantage; meanwhile, producers of complex machinery for which there is very little domestic demand at present are at the greatest disadvantage. Supplies to defense factories and their employees are falling drastically. The worst decline is probably being experienced by Moscow, whose main product—central government—is just not in demand any more.

Inside regional blocs, the distribution of products is usually handled by administrative means. Consumer goods are distributed legally through ration cards and coupons issued at work or by residence, or illegally at astronomical prices (usually two to three times the nominal price) that cover not only the cost of the goods but the costs of the punishable violation of trading regulations.

In the near future, we may expect that as administrative restrictions on commodity-money-commodity exchanges are relaxed and the transaction costs of such deals go down accordingly, a single ruble will emerge from the various types of cash and noncash money that exist today. However, as long as only the government can print currency, there will be no confidence in the value of Soviet money, and existing Soviet bank notes will not become a universal tool of exchange. The developments of the past few years show that the general public prefers new, better-controlled ways of limiting demand through currencies independent of the central state: coupons, vouchers, or ration cards.

Stable foreign currencies are already in wide use, and will be used more and more, as internal hard cash; however, this will not be enough to satisfy the demand for money circulation. Therefore, if Western banks were to undertake the printing of bank notes in the USSR, they could, on the one hand, reap huge profits and, on the other hand, do more to restore the Soviet economy than Western governments could do with aid programs and guaranteed credits.

Private money independent of the Soviet regime, particularly with reserves in Western banks, will enjoy more confidence in current Soviet conditions than government money. The Soviet Union has a spectacular opportunity to become the first country to implement Hayek's idea of competing currencies.

Self-Made Privatization

As the development of a mature administrative market and exchange relations proceeded in the Brezhnev era, organizations

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and individuals gained new rights, usually not encoded in law, or encoded only *a posteriori*. This process picked up with the start of perestroika, when the declining influence of vertical hierarchies of subordination drastically expanded the formal autonomy of legal entities.

The final disintegration of traditional hierarchies of subordination, which happened near the end of 1990, gave rise to an intensive process of self-made or spontaneous privatization. At first glance, it can be seen as normal commercial activity rooted in current legislation; upon closer inspection, as seizure of property and thievery; and, finally, upon mature analysis, as the best of the realistically attainable methods of privatization in this country.

The legal framework of this process is defined by the legislation of the years of perestroika, which gave freedom to organizations, not people. In the absence of real property owners, the expansion of the rights of organizations means, in reality, the transfer of prerogatives from the top bodies of power to the top managers of organizations. This process was boosted by the emergence of new types of business entities: cooperatives, joint ventures, and many others, which can be used to carry out transactions forbidden to ordinary state-run organizations. The emergence of these institutions opened channels for the privatization of state property by transfer to top managers of organizations.

A group of enterprises can, for example, set up its own commercial bank and deposit assets into it. The bank will thus belong to the enterprises and will be run by their chief managers. Then, the enterprises can issue shares to be acquired by a commercial bank, which will then own enterprises. The outcome is the establishment of a financial group fully controlled by the managers of enterprises.

A cooperative acting in concert with an enterprise can raise money to buy out the latter. The enterprise could also buy itself out, borrowing money and paying the debts by raising prices—but then the chief manager would get no more than any other worker, which is actually at odds with the already existing distribution of property rights. Therefore, it is more to the manager's advantage to enter a partnership with a cooperative, simultaneously becoming its co-owner (acting, in order to stay "clean," through another, intermediary cooperative). A number of such examples could be cited.

As a result of such transformations, property ownership in the Soviet Union is being transferred to the nomenklatura (deideologized party officials, heads of enterprises, and heads of departments), particularly young and middle-aged people; owners of cooperatives and joint ventures; and newly elected deputies of local soviets. They

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have one thing in common: They were all in a flurry of activity in the period of perestroika. They were the only ones who were willing to go into business when perestroika created still-limited opportunities for that. The rest of the population is either people best suited to follow directions (some of them outstanding employees) or future entrepreneurs in fields where there is as yet no room for private enterprise. Spontaneous privatization places property in the hands of those who want it and know what to do with it.

The crooked nature of this kind of privatization is, in many ways, a consequence of the ideologized envy that prevents society from taking a sober view of economic inequalities, and of the contemptuous underestimation of the nomenklatura's abilities by people who have never been in management. When I suggested recently that in the privatization process, managers should get a 20 percent share in the properties as a bonus, critics sneered that our stupid nomenklatura was unfit for the market and unworthy of such largesse. What will they say when the nomenklatura gets 50 percent of everything?

Spontaneously privatized properties are not given away for free; they are sold—but usually for noncash assets, which can always be easily obtained. These are assets accumulated in the accounts of enterprises (usually reflecting nothing more than the flaws in the system of pricing, deductions, and subsidies); of party organizations; and of cooperatives (usually earned by reselling foreign computers to state enterprises and providing them with scientific, consulting, and other, often phony, services).

Both the Communist party and the "democratic forces" are actively participating in this process. In the Communist party, the division between a managerial class that has already set aside profitable spots for itself in the new commercial structures and a relatively small group of "ideologues" associated with the Communist party of Russia is almost complete. The "democratic" circles that have come to power are being corrupted by involvement in business activities. In all likelihood, the process of transition to the market will be completed when all of the most active and the most influential members of the nomenklatura have found places for themselves in the new structures and the authorities no longer stand in the way of the transition. The redistribution of property and the cardinal change in the rules of the game can be carried out only by a totally new political movement enjoying broad popular support. And such a development, even if it were possible, should hardly be seen as desirable. The new regime would have to give industrial properties to people who have no need for them, taking them away from competent people who know how to use them.

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Unfortunately, the military-industrial complex is less involved in the privatization process, both because of its secrecy, religiously guarded to this day, and because of the discipline that always distinguished this sector of the economy. The military-industrial complex resents this all the more since, unlike the civilian economy, it has the country's best engineers, workers, equipment, and materials. The fact that the military-industrial complex is cut off from the division of state property is the main cause of the present political crisis in the USSR.

The self-made or spontaneous privatization described above does not at this point satisfy the Western criteria for private property. Thus, for instance, an enterprise can be sold but cannot be bequeathed. A businessman's sudden death could leave his heirs without property. However, anticipating his future demise, an entrepreneur undoubtedly can provide for his children. Privatization is now developing in two directions: It is broadening to include more and more enterprises, and deepening as actual property owners gain more extensive rights.

What is taking place is a powerful Hayekian process of reorganization of Soviet society, with a strictly regimented order being replaced by a spontaneous one. The weakness of the state, on the one hand, makes it impossible to fit this process into the distinct forms developed by Western culture; on the other hand, it protects society from recurrences of social engineering.

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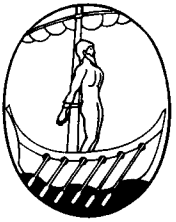

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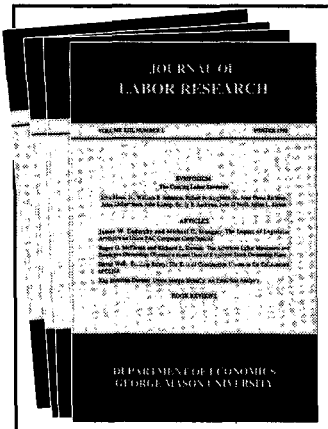

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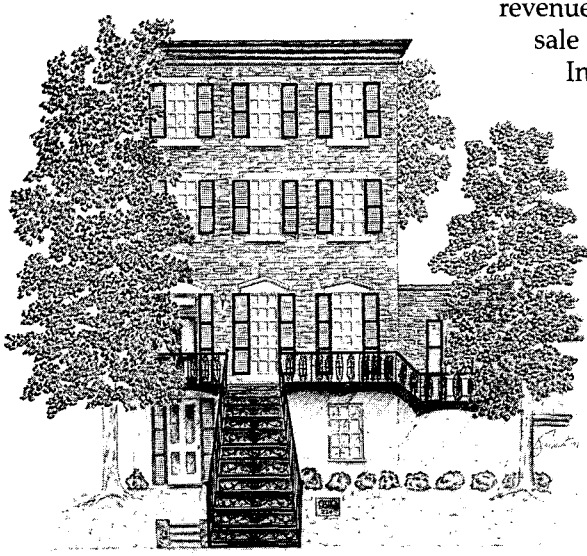

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—**Friedrich A. Hayek**

The Road to Serfdom
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1944), p. 107.

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